

Discussion Paper on Interest Rate Policy



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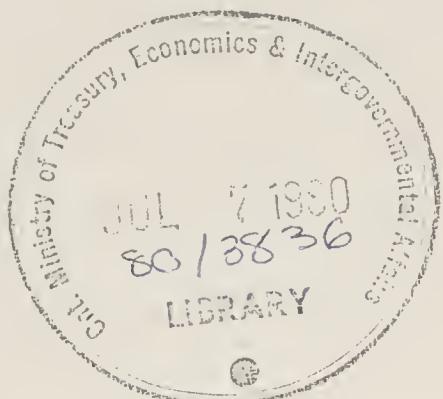


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PREFACE

In his 1980 Ontario Budget, the Honourable Frank S. Miller, Treasurer of Ontario, undertook to produce an interministry discussion paper on interest rate policy. This paper fulfills that commitment. Its purpose is to identify the source and consequences of the recent unprecedented high interest rates and to examine policy issues and alternatives.

When the Budget was tabled on Tuesday, April 22, the Bank rate in Canada was 15.67 per cent, close to the record high of 16.2 per cent reached earlier that month. As of June 5, only six weeks later, the Bank rate is at the much reduced level of 11.81 per cent. This is approximately the rate which prevailed during the late summer of 1979. Other interest rates, including those for mortgages and bonds, have also declined significantly. These very marked fluctuations over a short period of time reflect the unsettled international economic situation, high inflation, uncertain expectations, and federal monetary and exchange rate policies.

This paper traces the path of interest rates in Canada and identifies some of the underlying factors which have contributed to high rates. The paper investigates the impact of these high rates on particular sectors of the economy and discusses the relative ability of each sector to accommodate a temporary interval of high interest rates. The capacity to adjust by large business, small business, farmers, homeowners and governments, is discussed and possible options for government assistance to the most pressed sectors are reviewed.

It is hoped this paper will assist the Members of the Ontario Legislature and other interested individuals to assess the scope available to borrowers and lenders to adapt their activities to a period of temporarily high interest rates. It is clear that there is no substitute for long term economic

policies aimed to stabilize interest rates at lower levels in the future. Temporary, band-aid measures are not viable in the longer run. Lower inflation, enhanced productivity, more balanced industrial development and a resolving of growing fiscal imbalances in Canada are essential aspects of any lasting solution to Canada's economic problems.

This paper is a cooperative effort by the Ministries of Treasury and Economics, Agriculture and Food, Industry and Tourism and Housing. The contribution of private sector organizations in providing background and perspective to the subject of interest rates is very much appreciated.

TABLE OF CONTENTS

	Page
I CAUSES OF HIGH INTEREST RATES	1
The International Deficit and Inflation	4
The Capital Squeeze	14
II CURRENT POLICY DILEMMA	17
Inefficiencies of Monetary Policy	17
Implications for Fiscal Policy	19
Controlling Inflation	22
Reducing Canada's International Deficit	24
Controlling International Capital Flows	25
III THE IMPACT OF HIGHER INTEREST RATES IN THE SHORT TERM	27
General Effects of Higher Rates	33
Sectoral Effects of Higher Rates	34
IV BORROWERS' CAPACITY TO ADJUST TO HIGHER INTEREST COSTS	46
V THE ROLE OF GOVERNMENT	60
VI MECHANISMS FOR AMELIORATING THE IMPACT OF HIGH INTEREST RATES IN THE SHORT TERM	65
Support Private Sector Initiatives	65
Limited Subsidies Based on Need	66
Direct Rate Subsidization	72
The Farm Interest Assistance Program	74
Tax Relief	74
Regulation of Capital Markets	76
CONCLUSION	78
APPENDIX A - Farm Interest Assistance Program	79

LIST OF TABLES

Table 1	The Supply and Demand for Funds in Canada, 1978	2
Table 2	Canada's International Balance of Payments	6
Table 3	Net Balance For Major Categories in Canada's Current Account	7
Table 4	Unemployment, Inflation and the International Deficit in Canada	7
Table 5	Selected Canadian Interest Rates	11
Table 6	Canadian Productivity Performance	20
Table 7	Growing Fiscal Disparities in Canada, 1973-1978	21
Table 8	Real Rates of Return	28
Table 9	Real Rates of Return by Year on a Long Term Bond Issued in 1971	29
Table 10	Real Cost of Mortgage Credit	30
Table 11	Chartered Bank Rates and Spreads	31
Table 12	Estimated Impact of a Sustained Four-Point Hike in Interest Rates on the Canadian Economy	34
Table 13	Public Sector Deficits	35
Table 14	Federal Government Debt Charges as a Per Cent of Budgetary Revenue	36
Table 15	Outstanding Short Term Credit of Unincorporated Business	38
Table 16	Farm Income and Interest Costs, 1971 to 1979	40
Table 17	Farm Expenses and Interest Costs by Type of Operation, 1978	41
Table 18	Level and Growth of Consumer Credit, 1970-1978	42
Table 19	Impact of Rising Mortgage Rates on Monthly Payments	44
Table 20	1980 Current Mortgage Rollovers by Length of Term, Canada	44
Table 21	Demand for Debt Capital in Canada by Sector, 1971-1979	49

Table 22	Number of Bankruptcies by Type of Industry, Ontario	52
Table 23	Net Farm Income	54
Table 24	Number of Canadian Households Rolling Over Mortgages: Initial Gross Debt Service (GDS) Ratio and GDS After Rollover Under Alternative Mortgage Renewal Rate Assumptions	56
Table 25	Reduction in Monthly Payments Achieved by Extending Amortization	57
Table 26	Reduction in Monthly Payments Possible by Using a Graduated Payment Mortgage (GPM)	58
Table 27	Monthly Assistance Required to Meet 30 Per Cent GDS Criterion	69

LIST OF CHARTS

Chart 1	Short Term Interest Rates: An International Comparison	12
Chart 2	Long Term Interest Rates: An International Comparison	13
Chart 3	Long Term Canada Bonds, Annual Average Interest Rate	32
Chart 4	The Bank Rate and Conventional Mortgage Rate, Quarterly Averages	48

A DISCUSSION PAPER ON INTEREST RATE POLICY

I THE CAUSES OF HIGH INTEREST RATES

Canada has a highly capital intensive economy. The demand for funds is strong, exceeding the supply of domestic savings, and we borrow substantial sums abroad. In part, the strong demand is related to our climate and our geography. An abundance of natural resources and unusually long distances to markets are two distinguishing features.

The mining, transportation and refining of natural resources, the production of food and the provision of social infrastructure are activities that involve immense quantities of capital. The Canadian climate has also dictated that more resources be used in the construction sector to erect homes and factories that can withstand the extremes of harsh winters and warm summers. A demographic bulge in young home buyers has reinforced the demand for capital over the past decade. Moreover, the dramatic increase in the price of energy over the past six years has caused capital requirements for electric utilities expansion and frontier petroleum resources development to rapidly escalate. The retooling and refitting of Canadian machines and buildings for greater energy efficiency requires large amounts of capital.

Table 1 shows the Canadian demand for capital and details the sources of supply. A substantial portion of the demand for capital is supplied directly out of "own source" savings of Canadian businesses and individuals. However, most sectors of the economy are highly dependent on outside sources of financing, both domestic and foreign. Many large private corporations, public utilities and governments borrow heavily from abroad. For other Canadians, the

availability and cost of credit from major domestic financial institutions are crucial to their survival and growth. Whatever the source, the price of finance capital is of vital importance to Canadians and to the Canadian economy.

Supply and Demand for Funds in Canada, 1978
(\$ billion)

Table I

Demand for Funds

Consumer Credit	4.5
Bank and Other Loans	12.7
Mortgages	18.1
Bonds	17.8
Stocks	8.8
Short Term Paper	2.5
Treasury Bills	2.8
 Total Domestic Demand	 67.2
 Borrowing by Foreigners in Canada	 <u>1.5</u>
 Total Demand for Funds	 <u>68.7</u>

Sources of Funds

Persons and Unincorporated Business	9.2
Non-Financial Private Enterprises	2.1
Public Sector	3.9
Public Financial Institutions	2.5
Bank of Canada	1.5
Financial Institutions	41.6
 Total Domestic Savings	 60.8
 Canadian Borrowing Abroad	 <u>7.9</u>
 Total Supply of Savings	 <u>68.7</u>

Source: Financial Flow Accounts, cat. 13-002, Statistics Canada.

The Canadian economy is highly interdependent with that of the United States, and there is a free flow of capital between the two countries. To maintain net capital inflows from abroad without what the Bank of Canada believes would be disruptive fluctuations in the external value of the Canadian dollar, the Bank endeavours to keep interest rates in Canada roughly in line with those in the United States. It is important to note that international interest rates and currency values are closely linked. Given current economic policies, if U.S. rates move up, Canadian rates must move up by a similar amount to maintain the differential between the two rates or capital will flow out of Canada and the value of the dollar will decline. The actual differential between U.S. and Canadian interest rates is determined by a number of factors: inflationary expectations; the balance of payments position; industrial structure; the public sector deficit; political stability; and, the domestic supply and demand for capital. None of these factors is beyond the control of Canadians, but a dramatic redirection of public policy will be required to sustain Canadian interest rates at a level below those in the United States.¹

The following discussion of the balance of payments, monetary and exchange rate policy and growing capital needs, highlights many important issues.

¹ For discussion of these issues and policy alternatives see:

T. J. Courchene, The Strategy of Gradualism (Montreal: C.D. Howe Research Institute, 1978);

A. Donner and D. Peters, The Monetarist Counter-Revolution: A Critique of Canadian Monetary Policy 1975-1979 (Toronto: Canadian Institute for Economic Policy, 1979); and,

Wendy Dobson, The Exchange Rate as a Policy Instrument (Montreal: C.D. Howe Research Institute, 1980).

The International Deficit and Inflation

Canada's international current account deficit, which the Bank of Canada continues to finance through relatively high domestic interest rates to attract foreign capital, is clearly an important element in the current high interest rate dilemma.

The deficit first arose in part because of a failure to contain domestic inflation that resulted from a commodity export boom. Inflation was at the heart of the problem originally, and remains so today. The Bank of Canada's attempts to contain upward pressure on the Canadian dollar in the early 1970s by keeping Canadian interest rates low resulted in excessively rapid growth in the money supply. This set the stage for the high inflation in the mid and late 1970s.² Domestic interest rates are currently high to attract foreign capital because foreigners do not believe that Canada can sustain a fundamentally lower rate of inflation than our major trading partners. Canadian interest rates could be well below those in other countries if foreign investors believed that Canada could sustain a correspondingly lower rate of domestic inflation. Lower inflation would improve Canada's competitive position. This would improve the confidence of foreign investors in the Canadian economy and would give rise to prospects for a stronger dollar.

Since 1974, Canada has accumulated a huge deficit in the current account of its balance of international payments. This is the main reason the dollar has dropped in value. The balance has deteriorated from a small surplus of \$108 million in 1973 to a deficit of over \$5.0 billion in 1979. This trend is

² T. J. Courchene, Money, Inflation and the Bank of Canada: An Analysis of Canadian Monetary Policy from 1970 to Early 1975 (Montreal: C.D. Howe Research Institute, 1976).

illustrated in Table 2. What is disturbing about this deficit is not only its size, but also its composition. A few natural resource commodities account for a large surplus which is offset by major deficits in other sectors. The major source of the overall deficit has been a disappointing performance in trade in manufactured end products. Table 3 shows that the end-products deficit has risen from \$9.6 billion in 1975 to \$16.1 billion last year. In addition, net foreign payments for interest and dividends have skyrocketed to around \$5 billion in 1979, while the tourism deficit has been run up to over \$1 billion.

The composition of the current account deficit reflects the failure to address a number of fundamental problems of the Canadian economy. The immediate cause of the deficit's large size is the failure of governments to contain the stagflation effects arising from oil price escalation in 1974. At that time, domestic inflation eroded the competitiveness of Canadian industry at home and abroad. Coupled with a recession in the United States, this caused the current account deficit to balloon and unemployment to rise. Table 4 illustrates the concurrent rise in unemployment, inflation and the international trade and services deficit in the mid 1970s.

Canada's International Balance of Payments
(\$ billion)

Table 2

	1973	1975	1978	1979
Merchandise Trade Surplus	2.7	-0.5	3.5	4.0
Services & Transfers Deficit	<u>-2.6</u>	<u>-4.3</u>	<u>-8.8</u>	<u>-9.0</u>
Current Account Position	+0.1	-4.8	-5.3	-5.0
Long Term Capital Inflow (+)	0.4	3.9	3.3	3.2
Short Term Capital Inflow (+) ¹	<u>0.9</u>	<u>0.4</u>	<u>-1.3</u>	<u>3.7</u>
Capital Account Surplus(+)	-0.6	4.4	2.0	6.9
Increase in Foreign Reserves(-)	<u>0.5</u>	<u>0.4</u>	<u>3.3</u>	<u>-1.9</u>
Balance of International Payments	0	0	0	0

Source: Quarterly Estimates of the Canadian Balance of International Payments cat. 67-001, Statistics Canada.

- Notes:
1. Includes net errors and omissions and allocation of SDRs.
 2. The current account deficit is offset by the sum of capital account balance plus official intervention by the Bank of Canada so that the balance of payments is always zero.
 3. Sums may not add due to rounding.

Net Balance for Major Categories in Canada's
Current Account
(\$ billion)

Table 3

	1973	1975	1978	1979
Food, Beverage, Tobacco	1.3	1.5	1.4	2.0
Crude Materials	3.1	2.9	3.0	4.8
Fabric. Materials	4.0	4.2	9.9	12.3
End Products	-6.1	-9.6	-11.8	-16.1
Other Merchandise	0.4	0.5	1.0	1.0
Interest & Dividends	-1.3	-2.0	-4.4	-5.2
Travel	-0.3	-0.7	-1.7	-1.1
Transfers and Other Items	-1.0	-1.6	-2.7	-2.7
Current Account	+0.1	-4.8	-5.3	-5.0

Source: Quarterly Estimates of the Canadian International Balance of Payments, cat. 67-001, Statistics Canada.

Unemployment, Inflation and International Deficit in Canada

Table 4

	1973	1975	1978	1979
Unemployment (%)	5.5	6.9	8.4	7.5
C.P.I. (%)	7.5	10.8	9.0	9.1
Current Acc't Balance (\$B)	0.1	-4.8	-5.3	-5.0

Source: Statistics Canada.

While monetary policy was subsequently tightened and the Anti-Inflation Program was implemented to deal with inflation, the burden was thrown on fiscal policy to deal with rising unemployment. In this regard, the inability of governments in Canada to resolve the issue of the uneven distribution and investment of enormous domestic petrodollar flows was critical. As a result, many petroleum-importing provincial jurisdictions in Canada were obliged to implement policies to offset the recessionary effects of higher oil prices at a time when their revenue growth was eroded by economic recession and their expenditures fueled by inflation. Their budgets went deeply into deficit and they were forced to resort to greater borrowing. In addition, the Bank of Canada in 1975 and 1976 followed a high interest rate policy that kept Canadian interest rates well above those in the United States and encouraged private corporations and governments in Canada to borrow from abroad. The net result was that despite a fundamental weakening in Canada's competitive position, the value of the Canadian dollar remained at a premium to the U.S. dollar. This, coupled with already poor domestic cost performance, further hurt Canada's competitiveness. As well, it stimulated artificially high imports of goods and services which were financed by the large foreign borrowings of Canadians. For example:

- . Canada's foreign long term borrowing in 1976 was \$7.9 billion, \$4 billion more than in 1975. This occurred at the same time the current account deficit actually shrank by close to \$1 billion.
- . The sharp increase in foreign borrowing led to an appreciation in the value of the Canadian dollar by 3.1 per cent in 1976, a time when Canadian competitiveness was being eroded further. Economy-wide unit labour costs, in own currency terms, rose 8.1 per cent in Canada compared to 4.7 per cent in the U.S. following 1975's relative performance of 15.6 vs. 7.9 per cent advances respectively.

The "cheaper" borrowing abroad was illusory. Despite federal efforts to shore up the value of the Canadian dollar, it subsequently suffered an inevitable decline. This dramatically increased the debt service payments on previous foreign

borrowing, repayable largely in foreign currencies. Hence, the huge annual debt service costs have been compounded, such that debt servicing has now itself become a major factor in the overall current account deficit.

- . The delay in allowing the exchange rate to adjust meant even further accumulation of foreign debt between 1977 and 1979 to finance the large current account deficit --\$14.6 billion over the three-year period.
- . Consequently, the interest and dividend deficit, which had hovered around the \$1 billion mark annually for the 1967-1974 period, rose steadily from \$2.0 billion in 1975 to \$5.2 billion in 1979. This is equal to the overall deficit on the current account of the balance of payments.

Canadians are now in the position where the huge international trade and services deficit must be financed by enormous net foreign capital inflows. To compound the problem, the Canadian dollar is heavily depreciated from its value in the early 1970s and there is little room to maneuver for Canadian monetary authorities. Under current policies, Canada must continue to attract huge capital inflows of both short and long term money in order to offset the current account deficit, if undue downward pressure on the Canadian dollar is to be avoided. The question of the impact of a sharply lower dollar has been subject to wide debate. On the one hand, exports would be stimulated if productive capacity is available. As well, imports would be more expensive. These two developments would work to improve the current account situation. On the other hand, the lower dollar would increase the cost of debt servicing. It could also create great uncertainty about the future value of the currency and encourage a speculative outflow of capital. This would affect capital flows critical to our economic performance.³

³For a discussion of exchange rate policy in the context of both current events and future priorities see: Wendy Dobson, op. cit.

The 1979 OPEC oil price increases have also complicated the problem of trying to attract sufficient foreign funds to offset Canada's international trade deficit. Recent international oil price increases are adding roughly \$100 billion of new revenues to the international pool of liquid capital. The size of the Eurocurrency market has grown to approximately \$1 trillion. Much of this money has been lent to developing countries by Western private financial institutions. As the OPEC countries roll up large surpluses, the developed and non-oil developing countries record corresponding current account deficits. These deficits cannot be immediately eliminated through increased exports of goods and services to OPEC. Therefore, the scramble for financial recycling of petrodollars will worsen. As noted above, many countries, including West Germany and Japan, are following the North American lead in dramatically raising interest rates to attract these liquid funds to support their currencies. Currently, however, high interest rates are depressing economic activity in all oil importing countries, but without an improved prospect of effecting the real transfer of goods and services to OPEC. Charts 1 and 2 trace the dramatic rise of interest rates over the past year, with North America leading the way. Table 5 underscores this rise, but illustrates, as well, the volatility exhibited in the recent sharp drop in rates.

Selected Canadian Interest Rates
(per cent)

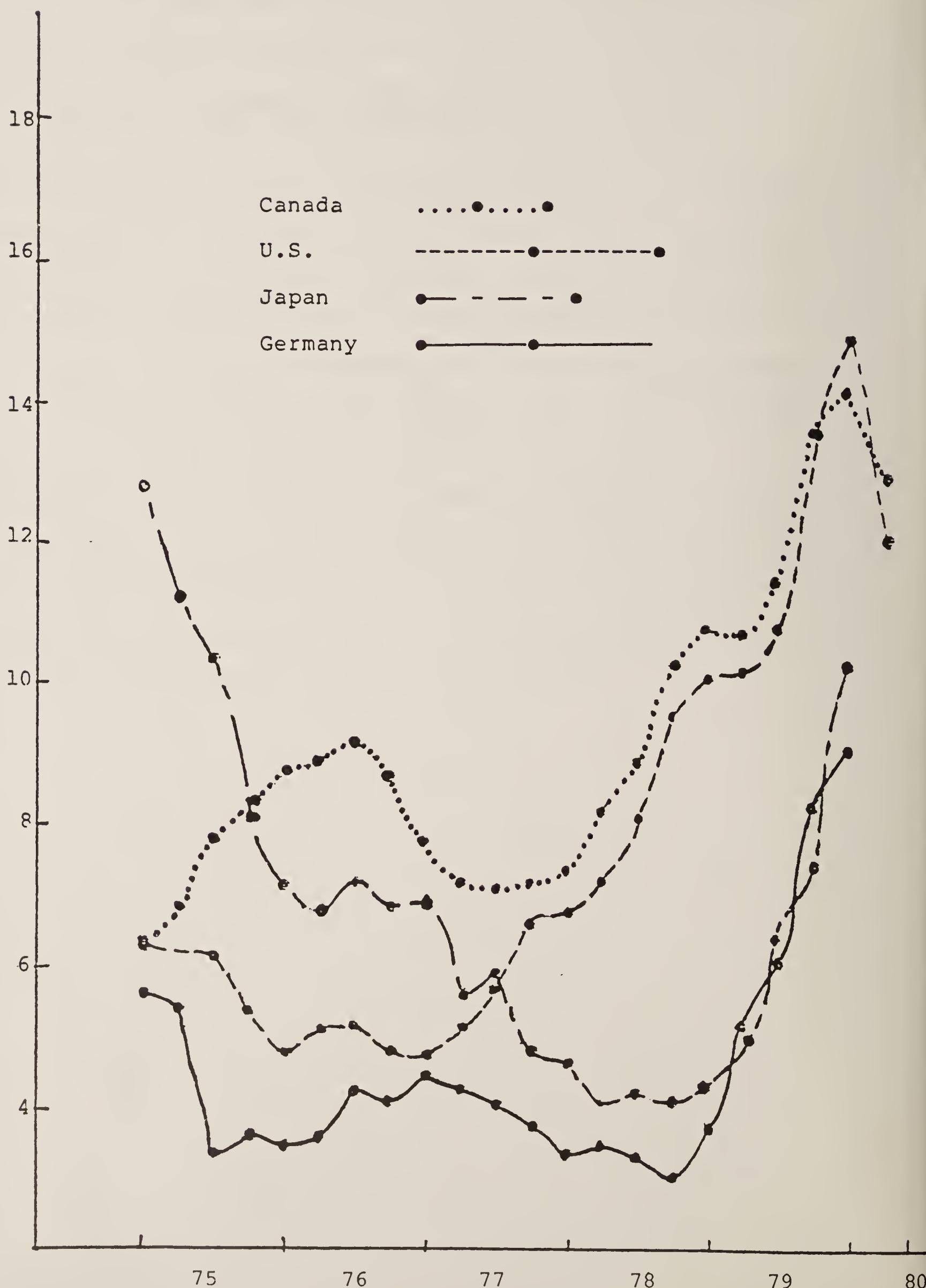
Table 5

	<u>May 29, 1980</u>	<u>May 30, 1979</u>	<u>1980 Peaks</u>
Bank Rate	11.83	11.25	16.20
3 Month Treasury Bills	11.58	10.84	15.95
1-3 Year Government Bonds	11.07	9.70	14.40
10- Year and Over Government Bonds	11.88	9.68	13.45

Source: Bank of Canada.

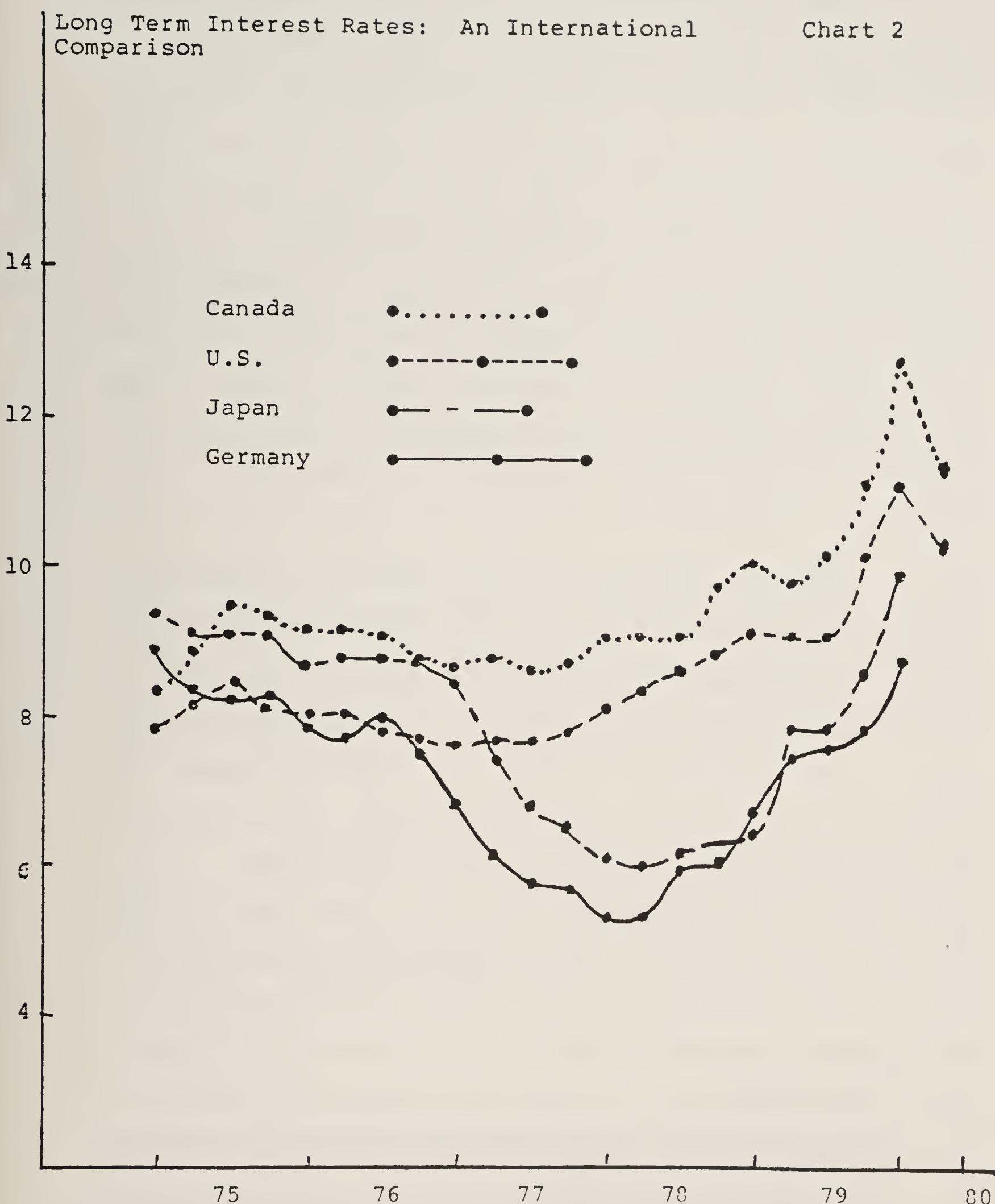
Short Term Interest Rates: An International Comparison

Chart 1



Long Term Interest Rates: An International Comparison

Chart 2



Source: Bank of Canada, International Monetary Fund

The Capital Squeeze

Apart from the impact of the current balance of payments situation on interest rates, there is growing evidence of a capital squeeze developing in Canada. Canadian industry is at a critical juncture. Massive new investment to retool for greater energy efficiency is an absolute necessity. Yet funds to finance this retooling could well be in short supply. Funds to finance huge new energy supply projects can reasonably be assured through a vast increase in revenue flows to that sector of the economy as well as ready financing in international capital markets. Other sectors, however, principally in manufacturing and service industries, will be competing for the savings of Canadians as well as in foreign capital markets. For these industries, there could well be a capital shortage in the future.

The saving-investment process in the world has been fundamentally altered by the sharp energy price escalation of the 1970s. The short term impacts have been well documented.⁴ But there are other longer term implications. The volume of funds created by oil price increases has sharply increased the potential supply of savings in the world. At the same time these price increases have accelerated the need to replace existing energy inefficient plant and equipment. This replacement process is complicated, however, by the fact that the relative rate of return in the non-energy sector has been reduced while being raised dramatically in the energy sector. Another complication has been the resulting

⁴ For examples, see:

International Economic Consequences of High Priced Energy (Washington: Committee for Economic Development, 1975);

Higher Oil Prices and the World Economy, E. R. Fried and C. Shultz ed. (Washington: Brookings Institution, 1975);

OECD Economic Outlook #25 (Paris: OECD, 1975); and,

T.A. Wilson, "Energy Policy, Overview and Macroeconomic Implications", Energy Policies for the 1980s (Toronto: Ontario Economic Council, 1980).

enormous imbalance in the allocation of savings between governments within Canada and between countries in the world. The net effects on the world financial system, the allocation of capital and the cost of capital are still uncertain, but the potential for a critical capital squeeze on certain sectors of the Canadian economy remains.

Although Canadian personal savings rates are close to 10 per cent and at high levels relative to the United States, they are not high by other international standards. In Japan the personal savings rate is around 20 per cent. In general, inflation in North America has undermined the confidence that individuals have in the savings process. High inflation has reduced real after-tax rates of return on savings to zero or even lower. In the United States, this process has proceeded to the point where personal savings rates have fallen to all-time lows. This represents a serious long run problem for U.S. industry, which must also install new energy efficient plant and equipment. But it also represents a problem to Canada, since Canadian industry has typically imported long term capital from the United States to finance a major part of its expansion. A capital squeeze in the United States could have serious repercussions on capital availability in Canada.

The automobile industry is a clear example of an industry that will require billions of dollars of investment capital to retool for more fuel efficient cars and auto parts. At the same time, however, the dramatic loss of market share to small, off-shore imports, coupled with the general recession brought on by high international oil prices and high interest rates has dramatically reduced cash flow to the industry. Much more of this retooling will have to be financed by external capital markets and by independent auto parts producers than has been the case in the past. The problem will be to ensure that this capital is available.

As finance capital becomes more scarce it is the small and medium sized firms that will be squeezed out of the markets first, either because of high

cost or quantity rationing. The Canadian situation is further complicated by the huge federal debt that must be financed. In 1979, the federal government deficit was \$9.2 billion, or 3.5 per cent of GNP. In fiscal 1980-1981, the federal deficit could require borrowing over \$1 billion per month. Financing a deficit of this size may well reduce the capital available to other domestic borrowers. Moreover, some argue that the bulk of this debt has gone to finance current consumption and not capital, at the expense of reducing future income for all Canadians.

II CURRENT POLICY DILEMMA

Inefficiencies of Monetary Policy

Canada's approach to its inflation problems and international payments deficit has been to maintain high domestic interest rates. The Bank of Canada's pursuit of a high interest rate policy is, in part, aimed at attracting capital inflows and shoring up an otherwise sagging Canadian dollar. By doing so, its principal advantage is that it reduces imported inflation -- an important factor in the Canadian economy. This thrust, however, has serious short run costs and is only a temporary expedient. It aims at financing Canada's external current account imbalance rather than turning it around. Indeed it could exacerbate the present problems by increasing future interest and dividend outflows. Yet long run, fundamental balance is the only lasting way of strengthening the Canadian currency and thus achieving greater policy independence.

While there is evidence of inflation in the Canadian foreign sector and in the domestic economy of oil-producing regions, most of the domestic economy is not overheated or in danger of producing a demand initiated inflationary push. Yet current monetary policy is designed to reduce demand across the entire domestic sector of the Canadian economy. High domestic interest rates will not reverse the demand pressures generated on the export industries. The foreign sector is not directly influenced by domestic demand conditions. It is possible that inflationary pressures could subside in this sector in 1980 as the U.S. economy goes into recession. That, however, would present a further conundrum of employment growth since both the foreign and domestic sectors of the economy could be suffering concurrently from insufficient demand.

There also is room for skepticism that monetary policy is likely to be successful, without very considerable costs in terms of unemployment, in reducing

the inflationary spillover from the export-import sectors into other sectors and regions of the domestic economy. What is unique about the current type of inflation is that it can, and does, co-exist with high levels of unemployment. Traditional wage setting and pricing behaviour and relationships between industries constrain the extent to which wages and prices respond to pressures of declining demand. In fact, each recession in North America over the past 20 years has been accompanied by a higher underlying rate of inflation. Recession does not appear to appreciably reduce inflation without having to become more and more severe. This tendency has been much accelerated by the OPEC oil crisis.

The most obvious conclusion is that if inflation problems originate in the foreign trade sector of the Canadian economy, then solutions should focus on this source. To some extent, of course, the current federal concern for preventing further depreciation of the Canadian dollar does address this issue. Currency depreciation is properly regarded as inflationary in Canada, perhaps without the usual potential for large gains in export sales. Fixation on this central objective through the use of high interest rates, however, has obscured the possibility that Canada may be able to achieve the exchange rate objective through other means. In the meantime, the heavy burden and the dampening effects of high interest rates will be imposed on some sectors and regions of the Canadian economy.

As noted above, inflationary pressures are not uniform through the various sectors of the Canadian economy. This is true not only with respect to different industrial sectors, as discussed above, but also for various regions. With its primarily export oriented industries, and its resource boom, principally in energy, Western Canada is experiencing strong inflationary pressures. These pressures are much less uniformly felt on labour and materials markets in the rest of Canada. Yet with a single national monetary policy, without compensating initiatives, it is the rest of the country that must shoulder the burden of the fight against inflation.

Table 6 illustrates the deterioration in productivity performance in the 1970s. Without substantial improvements in productivity, economic growth will slow sharply in the 1980s. Furthermore, high energy prices will sharply reduce real incomes in the non-energy sector of the economy. Only by enhanced productivity gains can these declines in real income be offset. The great danger, however, is that if productivity growth does not occur, or is unnecessarily delayed, Canadians will dissipate their efforts in fruitless squabbles over the distribution of a slowly growing national income. The most obvious manifestation of this will be in a new wave of domestic inflation. Hence the drive for improved productivity performance is essential not only for long run real income growth but also for the reduction of one of the major underlying causes of inflation.

Implications for Fiscal Policy

The dampening effects of high interest rates have been offset to some degree by fiscal policy. Initially, in 1975, this took the form of various tax cuts and expenditure initiatives to sustain economic activity.⁵ Increasingly, however, most provincial governments and the federal government have been constrained in following this course by their existing large budgetary deficits.⁶

⁵For a review of the stimulative actions taken by the federal government and the Government of Ontario, see Hon. W. Darcy McKeough, 1976 Ontario Budget (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs).

⁶Edward Carmichael, Reassessing Canada's Potential Economic Growth (Ottawa: The Conference Board in Canada, 1979) p.61

The long run damaging effects of such a policy can be substantial. High interest rates and slack domestic markets discourage investment. Yet it is investment which is clearly essential to Canadian productivity growth that has been so disappointing in recent years. Of course, there are many other factors which can contribute to improved productivity performance, but new plant and equipment and new business start-ups are clearly one way this can be achieved. In turn, our productivity performance is vital to Canada's international cost competitiveness and the control of inflation. By discouraging capital investment, current high interest rates not only dampen economic growth but also contribute to future inflation.

Canadian Productivity Performance
(per cent, average annual change)

Table 6

	<u>1961-1971</u>	<u>1971-1979</u>
Commercial industries	4.2	2.2
Goods-producing industries	5.4	2.7
Manufacturing industries	4.4	3.1

Source: Statistics Canada.

Growing Fiscal Disparities in Canada, 1973-1978
(\$ million)

Table 7

	1973	1974	1975	1976	1977	1978
Federal Government Position	387	1,109	-3,805	-3,356	-7,693	-11,357
Surplus Provinces ¹	302	780	556	1,141	1,731	2,217
Deficit Provinces ²	-404	-128	-2,312	-2,642	-2,242	-1,652

Source: Provincial Economic Accounts, cat. 13-213, Statistics Canada.

¹ Alberta and British Columbia.

² Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Ontario, Manitoba and Saskatchewan.

The failure to resolve the fiscal imbalances created by domestic oil and gas price increases shown in Table 7 has already weakened the capacity of governments to respond to the legitimate needs of those sectors of the economy most hurt by high interest rates, and yet least responsible for the current inflation. Fiscal policy in the past has been allocated the responsibility of dealing with the unemployment arising from international and domestic oil price increases while monetary policy has focussed on controlling the resulting inflation. The results have been only partially successful and point to the need for new policy initiatives to tackle the multi-faceted nature of the problems.

Controlling Inflation

The control of domestic inflation is essential to achieve lower interest rates in Canada and restore the strength of the Canadian dollar. Interest rates in Canada do not have to be higher than those abroad so long as foreign lenders believe that the Canadian inflation rate will be below that in other countries. If that is achieved, capital will continue to flow into Canada, even with lower nominal interest rates than abroad. The value of the currency will appreciate and imported inflation will also be diminished. Just as nations can become entrapped in a vicious circle of domestic inflation, exchange depreciation and more inflation, so too can they engineer a circle in the reverse direction. Japan and West Germany in the late 1970s were prime examples of this. The objective is to achieve effective control of domestic inflation, and the manner in which this may be accomplished need not be the same for all nations.

As outlined above, much of the current inflationary pressure in Canada stems from the foreign trade sector of the economy. A high interest rate policy is meant to contain this inflation by sustaining the value of the Canadian dollar. Its side effects, however, are to depress significantly economic activity in the non-inflationary sectors and regions of the economy and to inhibit long-run productivity growth. The control of domestic inflation by such a strategy is achieved at very substantial cost in terms of higher unemployment in the present, greater regional economic imbalance, and lower future income growth for the nation. Therefore, efforts should be made to find an anti-inflation strategy that is more focussed and, at the same time, promotes employment and productivity objectives.

Public sector employment restraint and gradual increases in domestic oil and gas prices, both provided a major assist to the effectiveness of the Anti-

Inflation Program in reducing domestic inflation in the period from 1976-1978. Indeed, the reduction of competing demands for resources by the public sector in Canada contributed strongly to the deceleration of real wage increases in the commercial sector. In addition, this strategy has been enormously successful in creating jobs in the private sector. Since 1976, the Canadian economy has created 890,000 jobs of which only 8,000 were in the government sector. This compares to a situation in the early 1970s where the government sector was creating an average of 71,400 jobs each year and accounted for 26 per cent of total employment growth between 1970 and 1975. These numbers are a tribute to the efficiency of public sector restraint programs, particularly at the provincial level.

Continued gradualism in the raising of domestic oil and natural gas prices will also be crucial to minimizing future domestic inflation. The inflationary impacts of large price jumps are well documented and go far beyond the immediate increase felt in the petroleum sector. Domestic crises in oil and natural gas pricing have in the past tended to be precipitated by international crises. This has compounded the domestic stabilization problems of higher energy costs because foreign markets are coincidentally going into decline.

Delinking domestic oil and gas prices from international oil prices will be a major first step.

As noted in the above analysis, the fiscal imbalances accompanying international and domestic oil price increases also require redress if the country is to have a coherent national economic stabilization policy. Balanced regional growth is one way to reduce the inflationary pressure on regional labour and materials markets that stems from low inter-regional resource mobility. But balanced regional growth cannot be pursued effectively in the absence of greater fiscal balance within Canada.

There is no single policy initiative that will ensure success against inflation. Action on many fronts will be essential to an efficient program. Renewed efforts to increase productivity, enhance labour mobility and reduce supply bottlenecks are also essential long run elements of an effective anti-inflation strategy. Fiscal restraint, coupled with increasing the supply of domestic savings from individuals and businesses, while providing a monetary climate conducive to investment, is the best approach to increasing productivity and raising future real incomes in Canada.

Reducing Canada's International Deficit

Canada's deficit of \$5 billion on the current account is well above recent historical averages in relation to the Gross National Product. As such, it represents a significant constraint on policy decisions with respect to the current management of the economy. Redress of this huge deficit would not only increase Canadian employment, it would strengthen the dollar, thereby reducing imported inflation and giving greater flexibility to Canadian economic policy.

The enormous international debt that Canadians have acquired in the 1970s implies that the nation will have to generate even larger trade surpluses in the future if it is to pay its way in the world. Maintaining international competitiveness through a concerted national anti-inflation strategy is only one aspect of the required effort.

The structure of Canada's international deficit is also of major concern. In the past, Canada has been fortunate in that it always found new resource exports to help pay for its imports. Resource export has been a trade strategy which, in many ways, has worked well and has been successful. Indeed, the processing and upgrading of raw resources for export will continue to be a

mainstay of the Canadian economy. Nonetheless, the current balance of payments crisis indicates the need for a strong commitment to an alternate strategy as well.

Reliance on resource booms have had a cost in terms of the postponement of a fundamental restructuring of the Canadian economy. In this regard, it is clear that Canada must increase its export capacity in the high-skill areas of the manufacturing and service industries. The nation's large and growing payments deficit in each of these areas reflect the degree to which the economy is being pressed into an increasingly narrow and hazardous focus.

The energy and energy-related sectors of the Canadian economy will themselves be major growth areas of the 1980s. If the nation is to achieve the greatest return from these projects, substantial efforts will be required to ensure that Canadian suppliers have full access to the domestic market opportunities created. A program of using domestic suppliers for energy projects could substantially reduce the cost to Canada of importing foreign equipment and skills. In energy supply, conservation and substitution, Canadians have an enormous development opportunity which must be used for the lasting benefit of the nation's economy.

Controlling International Capital Flows

As outlined above, a major justification for recent high short term Canadian interest rates is to ensure sufficient foreign capital inflow to finance Canada's huge balance of payments deficit on current account. Speculative capital movements have posed problems for all major currencies since 1973-74 when OPEC price increases suddenly shifted over \$60 billion to countries with low re-spending propensities. In the aftermath of the 1973-74 OPEC price hike, oil importing countries responded by deflating their economies and using floating exchange rates to avoid a drain on foreign reserves. High inflation and high

unemployment and the uncertainties surrounding these circumstances left the world economy awash in highly liquid assets. In consequence, a massive shifting around of this liquid international capital brought huge fluctuations in international exchange rates in the 1974-78 period. When OPEC prices once again jumped dramatically in 1979, the stage was set for another round of substantial liquid capital movements, wide swings in exchange rates and competitive interest rate escalation on an international scale.

The prevailing international financial climate is one in which over \$100 billion of new oil revenues are being added annually to the potential pool of liquid world capital as a result of the 1979 OPEC price hike. Industrial countries are currently engaged in an interest rate war to lure funds and protect their currencies. In such a world, stability in exchange rates could prove to be a difficult and costly goal. Much of the new international oil revenue, coupled with huge amounts of existing liquid funds, can be expected to drift into and out of currencies, stocks and bonds, commodities and precious metals as the international political climate changes, as expected current account positions of countries vary, and interest rate differentials between major financial centres fluctuate. Periodic oil price increases simply worsen the instabilities and the situation could remain in a state of flux for some time to come.

No measures can totally insulate Canada from the vagaries of international capital markets, nor is it necessarily desirable to do so. Canada's is an open economy with significant participation in world trade and finance. The benefits that flow from this participation are both large and varied. However, the object of economic policy in these uncertain times must be to ensure that these benefits are maintained and enhanced.

III THE IMPACT OF HIGHER INTEREST RATES IN THE SHORT TERM

The market price of credit in recent months has been historically high in nominal terms. It is important, however, for any realistic discussion of interest rate assistance to view high nominal rates appropriately. Whether or not the real cost of credit to the borrower and the rate of return to the lender is high in individual situations depends on who is borrowing and who is lending, and on what terms. The "real" cost of credit is the true cost to the borrower after allowing for the gain in the value of the asset purchased.⁷ For many years, lenders have received a very low or negative real return on their investments. This reflects the fact that during the 1960s and well into the 1970s, most medium and long term loans were made at fixed rates of interest, which did not anticipate the relatively high rates of inflation.

Table 8 shows the relationship between long term loans and inflation. Over time, interest rates have increased considerably, but the acceleration in inflation, particularly in the mid to late 1970s has meant a decline in real rates of return. In fact, in some years, the real rate of return has been negative.

⁷ The real interest rate at a time a loan is negotiated is influenced by inflationary expectations and the nominal rate of interest. It can be approximated by taking the difference between the contracted rate of interest and current inflation provided inflation is relatively stable over the term.

Real Rate of Return
(per cent)

Table 8

	Increases in GNE Deflator	Yield On Long Term Canadas	Real Rate of Return in 1st Year*
1961	0.5	5.1	4.6
1962	1.4	5.1	3.7
1963	1.9	5.1	3.2
1964	2.5	5.2	2.7
1965	3.2	5.2	2.0
1966	4.4	5.7	1.3
1967	3.9	5.9	2.0
1968	3.3	6.7	3.4
1969	4.4	7.6	3.2
1970	4.7	7.9	3.2
1971	3.2	6.9	3.7
1972	5.0	7.2	2.2
1973	9.1	7.6	- 1.5
1974	14.9	8.9	- 6.0
1975	11.2	9.0	- 2.2
1976	9.5	9.2	- 0.3
1977	6.5	8.7	2.2
1978	6.4	9.3	2.9
1979	9.9	10.2	0.3

Source: Statistics Canada and Bank of Canada Review.

* These figures do not take into account capital depreciation of the bond or tax considerations.

This relationship between real and nominal rates of interest is further illustrated by examining rates of return beyond year one. In 1971, a long term Canada bond with an annual yield of 6.9 per cent had a real rate of return of 3.7 per cent. But as inflation accelerated, the real yield fell, and was negative for most years of the decade. This is shown in Table 9.

Real Rate of Return By Year On a Long Term Bond
Issued in 1971
(per cent)

Table 9

	GNE Deflator	Yield on 1971 Long Term Canadas	Real Rate of Return By Year*
1971	3.2	6.9	3.7
1972	5.0		1.9
1973	9.1		- 2.2
1974	14.9		- 8.0
1975	11.2		- 4.3
1976	9.5		- 2.6
1977	6.5		0.4
1978	6.4		0.5
1979	9.9		- 3.0

Source: Statistics Canada and Bank of Canada Review.

* These figures do not take into account capital depreciation on the bond or tax considerations.

Table 10, which compares the nominal mortgage rate and the Consumer Price Index, gives a parallel illustration of what has happened to the real cost of mortgages. In the 1960s and early 1970s, mortgage borrowers paid substantial real rates of 5 per cent per annum on average. By the late 1970s, borrowers were paying considerably lower real rates -- about 2 per cent.

Real Cost of Mortgage Credit
(per cent)

Table 10

	Rate of Increase in CPI	Conventional Mortgage Interest Rate	Real Mortgage Interest Cost
1961	0.9	7.0	6.1
1962	1.2	7.0	5.8
1963	1.7	7.0	5.3
1964	1.8	7.0	5.2
1965	2.4	7.0	4.6
1966	3.7	7.7	4.0
1967	3.6	8.1	4.5
1968	4.0	9.1	5.1
1969	4.6	9.8	5.2
1970	3.3	10.4	7.1
1971	2.9	9.4	6.5
1972	4.8	9.2	4.4
1973	7.6	9.6	2.0
1974	10.8	11.2	0.4
1975	10.8	11.4	0.6
1976	7.5	11.8	4.3
1977	8.0	10.4	2.4
1978	9.0	10.6	1.6
1979	9.1	12.0	2.9

Source: Statistics Canada and the AERIC Historical Summary from the Conference Board in Canada.

Another point that merits attention is the issue of "spread." While the nominal spread between the rates financial institutions are now paying on deposits and what they are now charging for loans has increased, the overall effective spread of their total deposits and loans has diminished. This occurs because the lending institutions in the past committed more loans for long periods at fixed rates when rates were lower than they took in in fixed rate deposits. Table 11 illustrates this spread situation.

Chartered Bank Rates and Spreads¹

Table 11

	Savings Deposits (%)	Prime Loans (%)	Spread in Basis Points
1971	4.54	6.48	194
1972	4.00	6.00	200
1973	5.44	7.65	221
1974	8.50	10.75	225
1975	7.00	9.42	242
1976	7.83	10.04	221
1977	6.00	8.50	250
1978	7.04	9.69	265
1979 ²	10.13	12.90	277
1980 ²	12.00	15.25	325

Source: Bank of Canada Review

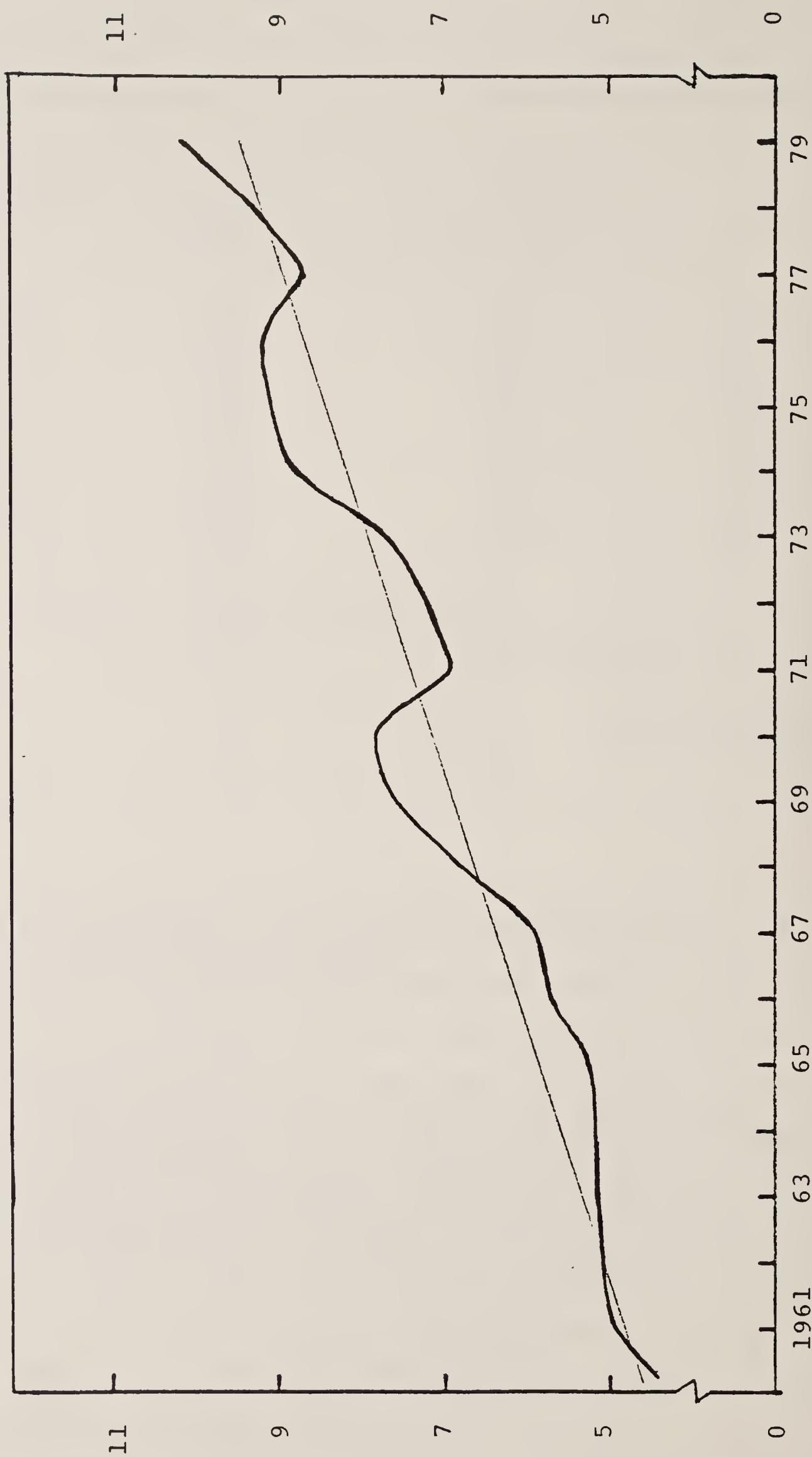
¹ Annual averages.

² First quarter average.

Growing inflationary expectations have caused lenders to rethink their investment policies. They have restructured the terms of their instruments and their rates to ensure, insofar as possible, positive rates of return, after allowance for inflation. The major impact has been felt in traditional long term debt in the form of bonds and mortgages. Chart 3 shows the gradual but persistent long term rising trend in interest rates. High interest levels reflect fundamental economic problems which must be faced at the national level with provincial support.

Canada Bonds - 10 Years and Over
Average Annual Interest Rate

Chart 3



Source: Bank of Canada

General Effects of Higher Rates

Higher domestic interest rates are meant to induce a large net inflow of foreign funds into Canada to finance the deficit in Canada's international trade in goods and services. This inflow of foreign capital helps to support the price of the Canadian dollar on international exchanges and alleviates the inflationary potential of a declining dollar. If the dollar falls, the cost of imported goods rises and contributes to overall inflation in Canada. To the extent that interest rate policies support the value of the dollar, they hold off the possibility of accelerating the rate of imported inflation.

It is also possible that high interest rates reduce inflation because they depress the growth of spending in the economy. Therefore, it is argued, the resulting excess capacity in the business sector and unemployment in the labour market will slow price and wage increases. This is true even though the immediate impact of higher interest rates is to raise costs and prices in some sectors, as for example the cost of homeownership and of business operations. However, while there is little question that high interest rates can substantially reduce economic activity, whether this will slow inflation, or at what cost it will do so (in terms of underutilized plant and higher unemployment), is now hotly debated among economists.⁸

High and rising interest rates impose significant costs on the economy. They do not simply raise the cost of doing business; they also undermine the demand for goods and services by causing postponement of spending by both consumers and business and squeezing business between rising costs and declining sales. The hardest hit sectors are housing, consumer spending on durable goods, and business investment in plant and equipment. Hence, the interest rates

⁸ A. Donner and D. Peters, op. cit.

reduce economic growth, lower job creation and raise the unemployment rate. For the Canadian economy, the impact on an annual basis from a sustained four-point increase in interest rates is estimated to be:

- . a lowering of real growth by between 1.2 and 2.1 percentage points;
- . a reduction of job creation by 44,000 to 59,000; and,
- . an increase in the unemployment rate of 0.4 to 0.5 percentage points.

These impacts are felt by an economy already suffering from a decline in export demand in the United States.

Estimated Impact of a Sustained Four-Point Hike
in Interest Rates on the Canadian Economy
(percentage points, on an annual basis)

Table 12

The Costs

Reduce Real Growth	-1.2 to -2.1
Lower Job Creation (000)	- 44 to - 59
Higher Unemployment Rate	+.4 to +0.5

The Benefits

Lower Inflation (C.P.I.)	-0.7 to -1.9
--------------------------	--------------

Source: Ontario Ministry of Treasury and Economics.

Note: These impacts do not reflect any potential dampening effect that interest rate increases may have on consumer and business confidence, or the simultaneously retarding effect the increase in U.S. interest rates will have on the United States economy and thus on Canadian exports.

Sectoral Effects of Higher Rates

The adverse impact of rising interest rates is not felt uniformly across the economy.

As interest rates rise, most borrowers feel the direct impact and experience a deterioration in their real income position. Governments, utilities, large and small business, farmers, homeowners and consumers alike seek ways to reduce the impact on their finances. The following paragraphs outline the nature of credit required by various categories of borrowers and show the impact of higher rates on each sector.

Government

With the exception of the resource rich provinces, the public sector in Canada has been running substantial deficits in recent years. For example, Table 13 shows that in 1979-80, the public sector deficit is estimated to be \$11.2 billion, mostly at the federal level. Government debt, particularly at the federal level, has been growing rapidly. Table 14 shows that interest on the federal public debt as a per cent of budgetary revenue was relatively stable from 1966-67 to the mid 1970s, but rose sharply in recent years, climbing from 11.4 per cent in 1966-67 to 20 per cent in 1978-79.

Public Sector Deficits
(\$ million)

Table 13

	1978-79	Estimated 1979-80
Oil and Gas Provinces' Annual Surpluses	+ 2,347	+ 2,400
Other Provinces' Annual Deficits	<u>- 2,605</u>	<u>- 2,050</u>
Net Fiscal Position of Provincial Sector	- 258	+ 350
Federal Deficit	<u>-12,103</u>	<u>-11,500</u>
Net Fiscal Position of Federal-Provincial Sector	<u>-12,361</u>	<u>-11,150</u>

Source: Ontario Treasury estimates based on data using a modified Financial Management Series concept.

Federal Government Debt Charges as a Per Cent
of Budgetary Revenue
(\$ billion)

Table 14

	Budgetary Revenue	Debt Service Charge	Debt Service Charge as a per cent of Budgetary Revenue
			%
1970-71	14.7	1.9	13
1971-72	16.3	2.1	13
1972-73	16.8	2.3	14
1973-74	21.9	2.6	12
1974-75	28.1	3.2	11
1975-76	30.0	4.0	13
1976-77	32.7	4.7	14
1977-78	32.9	5.6	17
1978-79	35.2	7.1	20

Source: Government of Canada Public Accounts.

Since 1975, the federal government has had to engage in substantial new borrowing to cover its operating deficits. The magnitude of these financial requirements has necessitated negotiation of long term debt at the prevailing high interest rates. The financing problem confronting the government is exacerbated by the term structure of Canada Savings Bonds, which comprise about 30 per cent of debt. These instruments carry a maximum term, but the lender may cash them at any time. Hence, in a period of rising interest rates, the government must either raise the coupon rate on outstanding bonds or experience a heavy run-off which in turn requires new contracts to be negotiated at higher rates. This means that as interest rates rise, the debt service burden of the federal government rises. And, as a consequence, its budget flexibility is reduced significantly.

Business

Business, both large and small, also feels the direct impact of higher credit costs. The term of business debt falls into three categories: long, intermediate

and short. Debt for plant and buildings is generally negotiated at a fixed rate for a long term. While high interest costs may curtail or postpone plans for expansion, long term credit costs do not squeeze business too hard. Increased costs can be passed on through the market place. Machinery and equipment tend to have intermediate terms. Where existing obligations have been negotiated at variable rates or debt is being rolled over, the costs of servicing the debt will rise. But business does have the flexibility not to enter into most new medium term obligations when rates are high. The key area where business is affected by higher interest costs is in short term working capital. The cash inflow of a business may not match its requirements for payments for raw materials, wages, inventory, etc. Credit for day-to-day operations cannot be postponed or avoided short of limiting operations. The increase in the cost of unavoidable short term credit requirements causes an income squeeze.

Table 15 gives an indication of the growth and magnitude of short term credit utilized by business.

Outstanding Short Term Credit of Unincorporated Business
(\$ billion)

Table 15

	Trade Payables	Bank Loans	Other Loans	Total	Growth Rate of Total
1970	5.2	4.3	2.2	11.7	-
1971	5.8	4.7	2.9	13.3	14
1972	5.6	5.2	2.9	13.7	3
1973	5.2	6.8	3.3	15.3	12
1974	4.2	8.0	5.1	17.4	14
1975	5.8	9.1	5.2	20.1	16
1976	5.8	11.6	5.8	23.2	15
1977	8.3	12.9	6.7	27.9	20
1978	10.1	15.0	6.1	31.2	12
1979	n.a.	n.a.	n.a.	n.a.	n.a.

Outstanding Short Term Credit of All Private Corporations
(\$ billion)

	Trade Payables	Loans		Financial and Other Short Term Papers	Total	Growth Rate
		Bank Loans	Other Loans			
1970	10.5	8.0	2.9	1.1	22.4	-
1971	11.6	9.4	3.0	1.4	25.4	13
1972	14.2	11.1	4.3	1.0	30.6	20
1973	17.5	13.7	5.1	0.9	37.2	22
1974	22.7	16.9	6.1	2.4	48.0	29
1975	24.2	19.3	7.1	2.6	53.2	11
1976	26.4	22.3	8.0	3.0	59.6	12
1977	31.3	21.4	8.7	3.1	64.5	8
1978	36.7	25.3	9.5	3.7	75.2	17
1979	42.6	29.9	11.0	4.6	88.2	17

Source: Financial Flow Accounts, cat. 13-002, Statistics Canada.

Note: Sums may not add due to rounding.

Farmers

Farmers feel the interest cost pinch as well. Farm debt falls into the three categories of long term, intermediate term and short term.

Long term debt, that is farm mortgages, will not present a problem for most farmers. Mortgages are mainly long term, fixed rate contracts from the federal Farm Credit Corporation, private sources or chartered banks. Intermediate term debt, for fixed assets such as machinery and equipment, is usually negotiated at a fixed rate for a given period. Farmers prefer to negotiate the loan for the expected life of the asset. In recent years, however, financial institutions have been tending toward shorter term contracts and in some cases loans may come due before the assets are paid for. Any new purchases of machinery and equipment are subject to prevailing rates, prime plus 1 on average. Some flexibility to postpone purchases exists.

The most acute problem facing farmers is working capital costs. This debt is short term and must be negotiated annually at the prevailing interest rate. There are over 40,000 commercial farmers in Ontario.⁹ The majority of these would be expected to engage in some short term financing. With most of the demand for funds to begin production falling in the Spring, it meant borrowing by farmers coincided with historically high rates this year.

Over 65 per cent of farmers' interest expense is for short term operating capital. Hence, the high short term rates experienced since the beginning of the farm production cycle will cause the overall interest burden to jump significantly in 1980. Inflation in prices of inputs such as seed, fertilizers and feed, have

⁹For purposes of this paper, a commercial farmer refers to one whose gross income from farming is \$8,000 annually or greater.

increased farmers' costs significantly. At the same time, prices for some farm products are low, particularly for commodities such as beef and hogs which are at the low point in their cycle and for coarse grains which are affected by the boycott of USSR markets.

This situation could have an adverse impact on the Ontario economy. Where farmers are able to pass on increased costs, consumers are affected by higher food prices. On the other hand, if farmers absorb the higher costs, the income squeeze caused by higher interest rates may reduce the attractiveness of farming as an occupation and erode the capacity of Ontario's food producing sector.

Table 16 shows total interest costs as a proportion of farm income (before interest charges) over recent years. The last three years reflect steady growth in interest payments, coupled with relatively poorer income growth.

Farm Income and Interest Costs, 1971 to 1979
(\$ million)

Table 16

Interest on Indebtedness	Net Income Before Interest Charges	Interest Charges	
		As a Per Cent of Income	Before Interest Charges (%)
1971	74.8	378.4	19.8
1972	99.7	531.8	18.7
1973	93.4	746.2	12.5
1974	131.6	580.3	22.7
1975	147.9	959.0	15.4
1976	183.5	944.4	19.4
1977	201.4	922.7	21.8
1978	252.9	1,087.3	23.3
1979	346.0	1,144.0	30.2

Source: Agricultural Statistics for Ontario and Proceedings of the Canadian Agricultural Outlook Conference.

Table 17 shows the relationship between total interest costs and farm income for various types of farming operations.

Farm Expenses and Interest Costs by Type of Operation, 1978
(dollars)

Table 17

	Interest Costs	Total Farm Expenses	Interest as a per cent of Total Expense
			(%)
Cash Crop	19,003	145,887	13.0
Sow Farrowing	7,036	69,216	10.2
Beef Cow	3,112	36,164	8.6
Dairy	5,825	69,339	8.4
Beef Feedlot	16,436	313,561	5.2
Hog Finishing	11,947	233,550	5.1

Source: Ontario Farm Management Analysis Project, Ontario Ministry of Agriculture and Food and University of Guelph.

Notes: 1. The figures refer to the financing of the average farm in the Ontario Farm Management Analysis Program.

2. Interest costs refer to charges on debt of all term. Figures do not reflect the relative importance of short term debt that is affected by the relatively high interest rates currently experienced.

Households

Individuals use credit for a variety of consumer items as well as for capital purchases. Table 18 shows the magnitude of and growth in consumer credit over time. The rapid growth in credit suggests that consumers made purchases of durables and other items on credit in anticipation of high income growth. Interest rates on consumer loans are generally fixed and higher interest rates will not cause existing debt to be a burden. High interest rates will cause consumers to postpone purchases, and there is an impact on economic growth.

Level and Growth of Consumer Credit, 1970 to 1978

Table 18

	Consumer Credit Level	Growth Rate
	(\$ billion)	(%)
1970	11.6	-
1971	12.5	8
1972	14.7	18
1973	17.5	19
1974	20.4	17
1975	23.6	16
1976	27.4	16
1977	30.8	12
1978	35.4	15

Source: Financial Flow Accounts, cat. 13-002, Statistics Canada.

Individuals are likely to be most sensitive to interest costs in the area of shelter. Shelter is the largest single expense in young families' budgets. The purchase of a home is the most substantial expenditure that consumers will make in their lifetime. It is a long term commitment and once undertaken, flexibility to alter demand is more limited than with other items in the budget. Capital cost is high in relation to income. As a rule of thumb, the house purchase price will be up to two and one-half times annual gross family income. This generally implies that a substantial part of the investment is undertaken through mortgage financing. At the beginning of the amortization schedule, interest costs make up the major proportion of the payment. Since interest costs are the prominent element, any increase in interest rates has a substantial and immediate impact on the size of payment required.

In Canada today, mortgages generally are rolled over every five years at a maximum. Increasingly, since 1975, shorter contracts have become more common.¹⁰ The interest rate which prevails at the time the mortgage is rolled over becomes the effective rate for the next contract term. When a mortgage is rolled over, higher interest rates means higher monthly payments.

Table 19 shows the increase in monthly payments on various mortgages negotiated at various interest rates. The jump in payments is fairly steep. For example, mortgages that were negotiated in 1975 at 11.25 per cent have had to be renegotiated since January 1980 in the range of 12 per cent to 17 per cent. On a \$50,000 mortgage amortized over 20 years with 15 years remaining, payments jump from \$516 to \$680 monthly where the rate increases from 11.25 per cent to 17 per cent -- approximately \$28 per point. This steep jump in interest rates and hence in payments is unprecedented. Furthermore, the recent sharp rise has taken place over a relatively short period of time and homeowners whose mortgages are up for renegotiation have not had a great deal of time to plan for such a steep increase.

In Canada, it is expected that 350,000 institutional mortgages must be renegotiated in 1980. Most of these should come up for renegotiation during the summer months since this is when house buying is concentrated. The Canadian Bankers' Association figures show that less than 20 per cent of renewals of mortgages held by banks occurred over the January to April period. Table 20 shows the distribution by term of mortgages which are due to be renegotiated in 1980 and the interest rates in effect at the time they were originally negotiated.

¹⁰ This contrasts with the U.S. situation where until recently all mortgages were negotiated with a fixed rate for the life of the mortgage. This situation has changed and regulations now permit a shorter term to be negotiated between the mortgagor and the mortgagee.

Impact of Rising Mortgage Rates
on Monthly Payments
(dollars)

Table 19

Size of Mortgage	Initial (1975) Monthly Payment at 11.25%	Size of Mortgage	Renewal (1980)			
			Monthly Payment At			
			14%	15%	16%	17%
20,000	206.38	18,160	237.09	248.62	260.32	272.15
30,000	309.56	27,240	355.63	372.93	390.47	408.23
40,000	412.75	36,320	474.18	497.24	520.63	544.31
50,000	515.93	45,400	592.72	621.54	650.77	680.38

Source: Ontario Treasury calculations.

Note: Assumes a 20-year amortization at initial term.

1980 Current Mortgage Rollovers by Length of Term, Canada

Table 20

Number of Borrowers	Average Rate at the time of Negotiation	Rate, January to May 1980
5-Year Term	263,000	11.2
3-Year Term	52,000	10.4
1-Year Term	35,000	11.4

Source: Central Mortgage and Housing Corporation.

Note: Conventional mortgage rates peaked at 17 per cent early in April. At the present time, mortgages are available at 12.5 per cent, a rate not available since the Autumn of 1979.

The new homebuyer is also affected by high interest rates. Some new homes, either in inventory or under construction , can be purchased with mortgages negotiated at lower than prevailing rates. However, the potential homeowner who must arrange a new mortgage has seen the monthly payment rise dramatically since the Autumn of 1979. At a mortgage rate of 12.25 per cent which prevailed then, a \$40,000, 20-year amortization mortgage would carry for \$440 monthly. At a rate of 16%, the monthly cost for the same mortgage would be \$541. Using the rule of thumb of 30 per cent of gross income as an appropriate maximum limit for costs of principal, interest and taxes, a family with \$19,600 annual income could have purchased a home with a \$40,000 mortgage in the Autumn of 1979. At a rate of 16 per cent an income of \$23,640 would be required. This reduced the number of families for whom home purchase was affordable. Thus, every additional point increase in interest rates has an ever greater dampening effect on the demand for new homes. In this context, while current rates of 12.5 to 14 per cent seem high, they are seen to be substantially more affordable than rates in the 16 to 18 per cent range.

Landlords rolling over mortgages experienced the same steep jump in payments that homeowners faced. The owners of about 50,000 units are expected to renegotiate their mortgage terms in 1980. A mortgage rate of 16 per cent would mean an increased cost of \$50 to \$100 per unit per month on average. Depending on the degree of tightness in the rental market, some of these costs may be passed on to the renter.

IV BORROWERS' CAPACITY TO ADJUST TO HIGHER INTEREST COSTS

The current situation of high interest rates is anticipated to be temporary. A sharp downward movement is now in progress. Chart 4 shows the rapidity with which the marked changes in rates occurred. It is unclear whether or not interest rates will resume a long term upward trend. As discussed earlier, policies must be pursued to direct the economy toward long term growth and stability. Even with the recent dramatic turnaround, high interest rates are a reality in the short term and borrowers must adapt and adjust their expectations.

Government

Governments may be perceived to have the least difficulty accommodating higher interest rates in the short term. To cover the higher costs of borrowing and of debt service, governments have the option of increasing their borrowing against future taxing power as well as that of raising taxes or at the federal level, monetizing debt.

While governments may have the easiest job of accommodating higher interest costs, they also bear the responsibility to ensure that the route they take in the short term does not undermine the achievement of long term growth and stability. Considerable debate has centered around the impact of government deficits on inflation.¹¹ Also, large amounts of government borrowing may result

¹¹ For examples of contributions to this debate, see:

Robert Crozier, "Deficit Financing and Inflation: Facts and Fictions" (Ottawa: Conference Board in Canada, 1976);

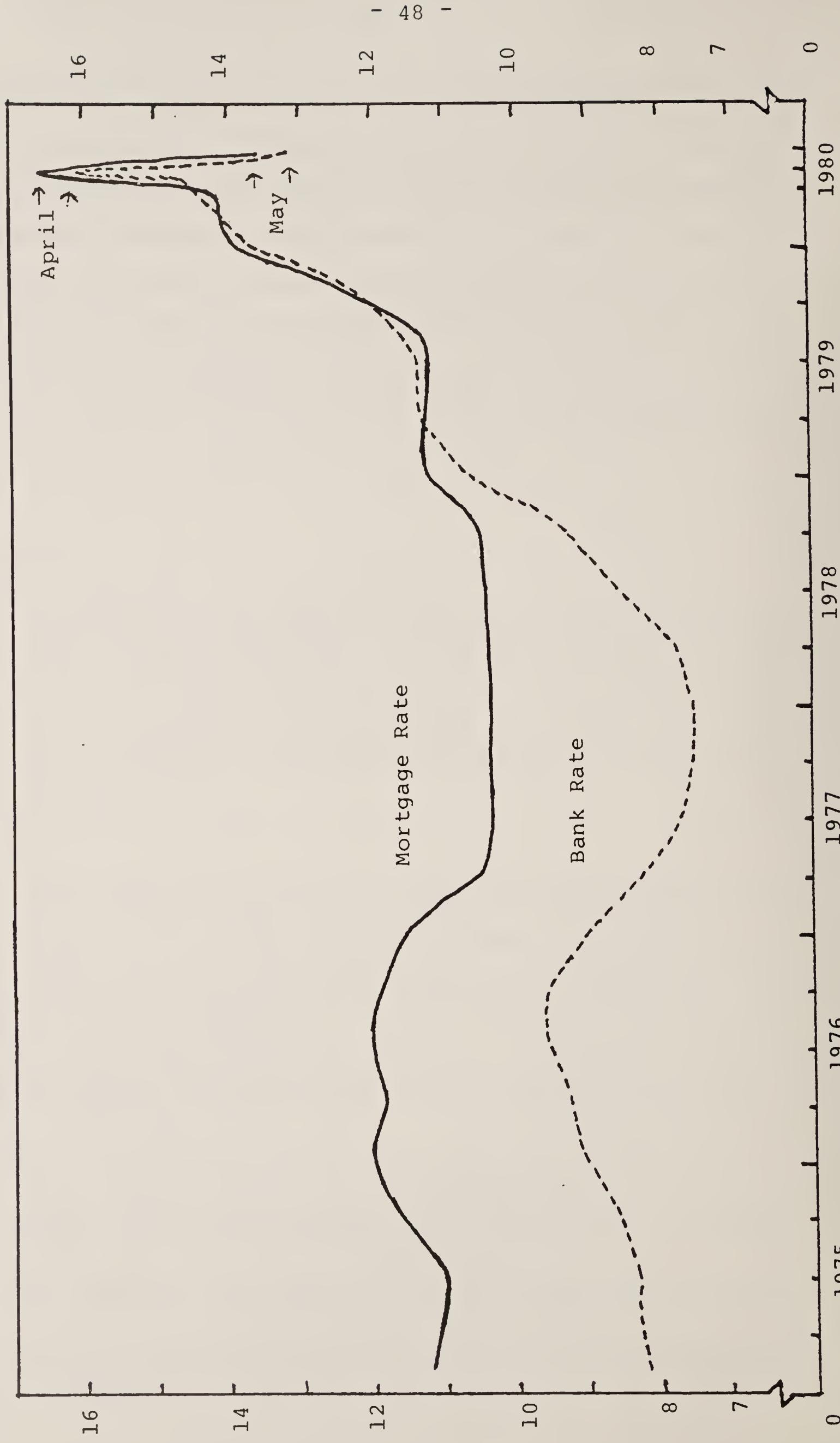
Robin Richardson, "Has Ottawa Had a Policy Relapse: Misconception or Misdirection" (Toronto: LOM Institutional Research, 1976); and,

John C. Pattison, "Government Deficits and Inflation Reconsidered" (Toronto: Ontario Economic Council, 1976).

in financial crowding out of the private sector and subsequently in reduced growth and employment. Table 21 shows the growing proportion of debt capital absorbed by governments and their enterprises. In 1979, the public sector absorbed 71 per cent of new capital, compared to 53 per cent in 1971. Hence, while governments may appear to have the greatest flexibility to adapt to higher interest rates in the short term without changing consumption and spending patterns, imprudent actions could make what should be a temporary period of high interest rates into more of a long term problem.

Quarterly Interest Rates

Chart 4



Source: Bank of Canada, Conference Board

Demand for Debt Capital in Canada by Sector, 1970-1979
 (percentage distribution)

Table 21

	1971	1972	1973	1974	1975	1976	1977	1978	1979
Private Financial Enterprises	46.0	52.8	59.9	69.1	20.4	24.7	21.0	16.3	29.0
Government Non-Financial Enterprises	21.3	22.5	33.6	28.8	34.5	35.6	31.1	29.9	30.0
Government Financial Enterprises	1.3	1.0	1.7	2.1	2.4	.2	1.8	1.7	2.4
Government	24.3	23.6	3.2	-	42.7	39.6	46.1	52.2	38.4
Rest of the World	7.1	-	1.6	-	-	-	-	-	-
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

- 49 -

Public Versus Private Sector Borrowing

Public Sector	46.9	47.2	38.5	30.9	79.6	75.3	79.0	83.7	71.0
Private Sector	53.1	52.8	61.5	69.1	20.4	24.7	21.0	16.3	29.0

Source: Financial Flow Accounts, Cat. 13-002, Statistics Canada.

Note: Sums may not add due to rounding.

Business

Big business, including corporate landlords and large construction companies, will weather higher rates in the short term. Capital expenditures for expansion can be postponed if necessary. Dividends may be reduced. Productivity may be improved in order to reduce the need for working capital. And some working capital is available from past profits. The proven track record of large companies means that credit is available to them as they need it. Diversity of operations, past profitability and expected future profits allow big business to sustain losses for some time. Increased interest costs are also a deductible business expense against taxes.

Similarly, small business can economize on the use of borrowed money. Expansion plans and the purchase of fixed assets can be postponed. Nonetheless, short term working capital is required and for small business it must often be borrowed.

The scope for minimizing the outlay for interest costs for the small business person lies in increasing efficiency and reducing expenses. Economizing on inventories, reductions in staff hours, and reducing the incomes of owners and senior managers offer the most significant savings.

The categories of small business with the most difficulty in coping with high rates are those which must carry large inventories and accounts receivable. Wholesalers and retailers are major groups. Some classes of small business, such as those manufacturing for export, may be able to recoup some of their higher costs through higher prices. Other groups, such as retail trade and personal service, may have more limited scope for recapture of costs.

In cases where higher expenses for interest cannot be recouped through higher prices, a definite income squeeze occurs. However, this is one of the risks associated with business. Incentives to take risk are provided in the tax system and companies experiencing an income squeeze today may be making significant profits down the road. Also, small business does have some cushion built in against higher interest as interest expense is tax deductible. The sector is well supported by government incentives. Small business currently receives substantial on-going support from government. Included among the recent initiatives are:

- Provincial grants to assist with research and development and to support the development of professional marketing approaches;
- \$50 million assistance in the 1980 Ontario Budget - including reduced capital tax for small business and the Small Business Tax Credit;
- doubling of limits on Ontario Development Corporation (ODC) loans to \$500,000, doubling of limits to ODC loan guarantees to \$500,000 and doubling of ODC export support loans to \$1,000,000; and,
- Small Business Development Bonds proposed in the federal budget, and limits on loan guarantees under the federal Small Business Loan Act raised to \$100,000.

In addition, the ODC has frozen its loan rates for the past 6 months. Money is being loaned to Ontario small business at a rate of 12.5 per cent.

In general, small business has been coping with high interest rates. Lenders recognize the temporary nature of the problem. Where there is difficulty for an enterprise that is viable in the long run, financial institutions are willing to grant credit.

Most evidence shows that viable entities can weather the storm. Lending institutions suggest that the problem of small business loan delinquency has not been exacerbated by high interest rates. In fact, the rate is lower than a year ago.

Table 22 shows that while bankruptcies in the first four months of 1980 are above those during the same period in 1979, the growth in the number of

Number of Business Bankruptcies by Type of Industry
Ontario

Table 22

	Total	Primary	Manufacturing	Construction	Transport. & Commun. & Util.	Wholesale & Retail Trade	Financial Insur. & Real Estate	Service
1970	1,212	70	108	208	98	45	186	
1971	1,237	74	120	175	97	546	184	
1972	1,231	66	96	235	104	524	177	
1973	1,219	50	80	259	116	523	162	
1974	1,155	27	66	229	149	496	162	
1975	1,270	17	70	189	29	347	200	
1976	1,308	18	141	190	140	475	356	
1977	1,660	53	126	291	115	685	460	
1978	2,124	71	165	387	142	706	619	
1979	2,223	81	190	475	136	706	84	
Jan. 1979	174	4	20	35	12	55	41	
Jan. 1980	219	9	14	54	13	81	42	
Feb. 1979	159	6	16	34	5	49	3	
Feb. 1980	242	10	17	50	19	81	7	
Mar. 1979	212	6	16	26	17	73	13	
Mar. 1980	205	7	19	54	12	55	7	
Apr. 1979	169	3	17	40	10	58	6	
Apr. 1980	192	14	16	57	12	61	10	
Jan. to Apr. 79	714	19	69	135	44	235	29	183
Jan. to Apr. 80	858	40	66	215	56	278	30	173

bankruptcies is lower than it has been in past years.

Farmers

For farmers, the capacity to minimize the effects of high interest rates is limited.

Long and intermediate term credit costs do not present an insurmountable problem for most farmers as some purchases can be postponed. Short term working capital is necessary, however, for the purchase of the direct variable inputs for production. In the absence of accumulated savings, many farmers must borrow to cover operating expenses until the crop or other product is sold. Higher interest rates put a squeeze on farm income.

To reduce the need for short term credit, the farmer can cut personal expenses or reduce production. As well, interest on working capital is a deductible expense from income taxes and, hence, farm income is to some degree cushioned from the effects of higher interest rates.

For the most part, Canadian farmers are price takers in world markets, so there is little opportunity to recoup higher costs directly through higher prices.

The main exception to this is farmers in the national supply management groups. There are 15,000 dairy, egg and poultry producers who have pricing formulae which either implicitly or explicitly compensate for higher interest costs.

Discussions with the financial institutions indicate that credit availability will not be a problem to the farming community in Ontario. If farmers are willing to pay higher interest costs, banks are willing lenders for well managed farming operations. Terms and conditions are flexible, being tailored to individual

circumstances. However, some farm operators may experience difficulties in obtaining adequate working capital.

While interest costs will pressure farm incomes, Table 23 shows that the farming sector has experienced strong income growth over the 1970s, which could provide some cushioning of the impact of higher interest costs for well-established farmers. However, it also shows that income is very unstable, and over the past four years, income growth has been just about zero.

Net Farm Income

Table 23

	Net Income (\$ million)	Income Growth (%)
1971	303.6	
1972	432.1	42.3
1973	652.8	51.1
1974	448.7	-31.3
1975	811.1	80.8
1976	760.9	-6.2
1977	721.3	-5.2
1978	834.3	15.7
1979	788.0	-5.5

Source: Agricultural Statistics for Ontario 1941-78 and Proceedings of the Canadian Agricultural Outlook Conference.

Homeowners

Since 1975, both incomes and housing values have increased. For many homeowners, the percentage of gross family income devoted to mortgage payments has dropped in the past five years. Typically, the servicing costs of mortgages contracted at the now prevailing interest rates will not represent a higher portion

of gross family income than was the case when the mortgage was initially contracted. Table 24 shows the gross debt service ratios for Canadian homeowners at the time of the original contract and at rates from 14.5 per cent to 17 per cent.

In addition to adjustments to household budgets and reordering of priorities by the homeowner, it is also possible to accommodate the cash flow problem presented by the higher rates through a number of financial mechanisms.

Extended Term: Extending the term of the mortgage reduces the cash flow burden. At a rate of 16 per cent, lengthening the term of a \$30,000 mortgage initially negotiated in 1975 at 11 per cent from 20 to 30 years would mean a drop in monthly payments from \$390 to \$359. For every year added to the term of the loan, additional long term interest costs accrue and the incremental cash flow benefits tend to diminish. Nevertheless, this approach may be adequate for many homeowners and provide a major portion of the accommodation required for many more.

Table 25 shows the financial flexibility that such measures would introduce to a family budget.

Number of Canadian Households Rolling Over Mortgages By Initial Gross Debt Service Ratio and Gross Debt Service Ratio After Roll Over Under Alternative Mortgage Renewal Rate Assumptions

Table 24

		GDS Ratios in 1980 After Roll Over: Mortgage Rate Ratio of Renewal = 17%									
		Mortgage Rate Ratio of Renewal = 16.5%									
		Mortgage Rate Ratio of Renewal = 16%									
Original GDS Ratio	Number of Borrowers	14.5%	15%	15.5%	16%	16.5%	17%	17.4	17.9	18.2	19.2
0 - 15.0	13,150	0 - 11.9	0 - 12.2	0 - 12.6	0 - 12.9	0 - 13.3	0 - 13.7	-	-	-	-
15.1 - 18.0	19,462	12.0 - 14.2	12.3 - 14.7	12.7 - 15.1	13.0 - 15.5	13.4 - 16.0	13.8 - 16.4	-	-	-	-
18.1 - 20.0	18,936	14.3 - 15.8	14.8 - 16.3	15.2 - 16.8	15.6 - 17.2	16.1 - 17.7	16.5 - 18.2	-	-	-	-
20.1 - 23.0	35,768	15.9 - 18.2	16.4 - 18.7	16.9 - 19.3	17.3 - 19.8	17.8 - 20.4	18.3 - 20.9	-	-	-	-
23.1 - 27.0	57,597	18.3 - 21.4	18.8 - 21.0	19.4 - 22.7	19.9 - 22.7	20.5 - 23.3	20.9 - 24.6	-	-	-	-
27.1 - 30.0	46,814	21.5 - 23.7	22.1 - 24.4	22.8 - 25.2	23.4 - 25.9	24.0 - 25.9	24.6 - 27.3	-	-	-	-
30.1+ -	71,273	23.8+	24.5+	25.3+	26.0+	26.7+	27.4+ -	-	-	-	-
	<u>263,000</u>										
0 - 15.0	3,380	0 - 15.5	0 - 16.0	0 - 16.4	0 - 16.9	0 - 17.4	0 - 17.8	-	-	-	-
15.1 - 18.0	4,056	15.6 - 18.6	16.1 - 19.1	16.5 - 19.7	17.0 - 20.3	17.5 - 20.8	17.9 - 21.4	-	-	-	-
18.1 - 20.0	4,420	18.7 - 20.7	19.2 - 21.3	19.8 - 21.9	20.4 - 22.5	20.9 - 23.2	21.5 - 23.8	-	-	-	-
20.1 - 23.0	8,112	20.8 - 23.8	21.4 - 24.5	22.0 - 25.2	22.6 - 25.9	23.3 - 26.6	23.9 - 27.3	-	-	-	-
23.1 - 27.0	10,920	23.9 - 27.9	24.6 - 28.7	25.3 - 29.6	26.0 - 30.4	26.7 - 30.4	27.4 - 32.1	-	-	-	-
27.1 - 30.0	6,916	28.0 - 31.0	28.8 - 31.9	29.7 - 32.9	30.5 - 33.8	31.4 - 34.7	32.2 - 35.7	-	-	-	-
30.1+ -	14,196	31.1+	32.0+	32.0+	33.0+	33.9+	34.8+ -	-	-	-	-
	<u>52,000</u>										
0 - 15.0	2,240	0 - 16.6	0 - 17.1	0 - 17.7	0 - 18.2	0 - 18.7	0 - 19.2	-	-	-	-
15.1 - 18.0	2,765	16.7 - 20.0	17.2 - 20.6	17.8 - 21.2	18.3 - 21.8	18.8 - 22.4	19.3 - 23.0	-	-	-	-
18.1 - 20.0	3,780	20.1 - 22.2	20.7 - 22.9	21.3 - 23.6	21.9 - 24.3	22.5 - 24.2	23.1 - 25.6	-	-	-	-
20.1 - 23.0	6,580	22.3 - 25.5	23.0 - 26.3	23.7 - 27.1	24.3 - 27.8	25.0 - 28.6	25.7 - 29.4	-	-	-	-
23.1 - 27.0	9,275	25.6 - 29.9	26.4 - 30.9	27.2 - 31.8	27.9 - 32.7	28.7 - 33.6	29.5 - 34.5	-	-	-	-
27.1 - 30.0	5,215	30.0 - 33.3	31.0 - 34.3	31.9 - 35.3	32.8 - 36.3	33.7 - 37.3	34.6 - 38.3	-	-	-	-
30.1+ -	5,145	33.4+	34.4+	34.4+	35.4+	36.4+	37.4+ -	-	-	-	-
	<u>35,000</u>										

Source: Central Mortgage and Housing Corporation based on an extrapolation from NHA loan experience.

Note: It is assumed that households experience the average rate of income growth. The average increases over the various terms were:

Five-Year 1975-80 57 per cent
 Three-Year 1977-80 27.6 per cent
 One-Year 1979-80 10.4 per cent

Reduction in Monthly Payment Achieved by Extending
Amortization

Table 25

Interest Rate Rene- gotiation	From 20 to 25 Years		From 20 to 30 Years	
	% Reduction	\$ Reduction per \$10,000 of Orig. Mortgage	% Reduction	\$ Reduction per \$10,000 of Orig. Mortgage
14%	6.9	8.20	10.1	11.90
15%	6.2	7.70	9.0	11.10
16%	5.6	7.30	8.0	10.40
17%	5.0	6.90	7.1	9.70

Source: Ontario Treasury calculations.

Note: These calculations assume a five-year term, 20-year amortization, and an interest rate of 11.25 at the initial time of negotiation.

The Graduated Payment Mortgage: The graduated payment mortgage (GPM) is a means of recognizing income growth and inflation in home values in determining the stream of loan repayments. The GPM provides for payments in the early years which are lower than would be required to meet the interest payment and retire the principal over the term. In later years, payments are increased to cover the amounts previously unpaid. Provided that income rises over the period, mortgage payments can remain a constant proportion of income over time. One example of the GPM principle is the AHOP program.

This financial mechanism is not generally offered by the financial institutions. It relies on future appreciation in the value of a home and it assumes that larger payments may be accommodated more readily a few years down the road. In

addition, in order to make use of this instrument possible, tax impediments must be removed and additional mortgage insurance must be provided by the government. The impact of this particular mechanism on monthly carrying costs is shown in Table 26.

Reduction in Monthly Payment Possible by Using
a Graduated Payment Mortgage (GPM)
(per cent)

Table 26

Mortgage Rate at Rollover in 1980	Rollover Period	Ave. Increase in Payment	Reduction Through GPM
14.5	1 year	22.6	18.5
	3 years	31.8	18.3
	5 years	24.2	18.0
15.0	1 year	26.2	18.0
	3 years	35.7	17.8
	5 years	27.9	17.5
15.5	1 year	30.0	17.5
	3 years	39.8	17.3
	5 years	31.7	17.1
16.0	1 year	33.6	17.0
	3 years	43.7	16.8
	5 years	35.4	16.6
16.5	1 year	37.8	16.5
	3 years	49.5	16.4
	5 years	42.5	16.2
17.0	1 year	41.5	16.1
	3 years	53.4	16.0
	5 years	46.1	15.8

Source: Central Mortgage and Housing Corporation.

Borrowing Against Equity: Other mechanisms take advantage of the increased equity that homeowners may have accumulated. For example, a homeowner who took out a \$30,000 mortgage in 1975 at 11.25 per cent will have reduced outstanding principal by \$2,760 by 1980. Capital appreciation may have

occurred as well. The homeowner could borrow against this equity to provide supplementary cash to carry higher mortgage rates. A moratorium on principal repayment provides similar flexibility to the homeowner by reducing current carrying costs.

Homebuyers

Most homebuyers possess considerably more flexibility than existing homeowners rolling over mortgages. New homebuyers have the option to postpone the purchase if interest rates are prohibitive. As well, builders' inventories primarily consist of homes financed from cheaper money borrowed previously, so these lower costs could be passed on to the new homebuyer. On the resale side, there is some flexibility in the form of vendor take-backs, as well as the ultimate flexibility to postpone the purchase.

Renters

Landlords facing higher mortgage costs will try to pass costs on to renters. Rent review legislation permits landlords to pass on increased costs. However, it is not certain the vacancy rates are low enough to permit a full pass through. Landlords may be forced to absorb some of the costs so that the rents remain competitive with those in buildings where there is no rollover. If increases are passed on to the renter, this may in turn affect their affordability situation.

V THE ROLE OF GOVERNMENT

In the context of this discussion paper, governments' first and foremost objective must be to operate monetary and fiscal policies that promote long term growth and stability. In this regard, monetary policy is the responsibility of the federal government. Both federal and provincial governments have the capacity to carry out fiscal policy and these policies must be carefully coordinated.

Interest rates are currently falling from record peaks reached in April. As rates fall, the need for government assistance is reduced as borrowers will be better able to finance their activities. However, fluctuations in interest rates have an uneven impact across the economy. In determining if there is a need for short term interest rate assistance for the most vulnerable segments of the economy, two critical questions must be addressed. These are:

1. Do the unanticipated costs associated with high interest rates constitute a burden on homeowners, farmers and small business above and beyond that to which they are capable of adjusting?
2. Should these enterprises be required to bear the costs of adjusting to the policy followed by the government or are there features about the tight monetary stance which distinguish it from other policy positions taken and make government intervention appropriate?

Discussions with representatives of the financial community indicate an adequate availability of capital. In their opinion, the majority of borrowers could handle the interest rate surge without government assistance. In fact, the Canadian Bankers' Association figures show that out of over 13,000 renewals that were negotiated with major chartered banks during the January to April period, only two hardship situations were referred to the head office. Both of these were accommodated.

Lenders are accommodating homeowners, farmers and small business in a flexible manner tailored to individual situations. This natural response by institutional lenders will soften the impact on most borrowers and has the effect of smoothing the hump in interest rates. Nonetheless, it does involve some sacrifices by borrowers.

Some homeowners with poor income growth prospects and little possibility for appreciation in the value of the house, or business with a heavy debt load and little chance for growth, will face pressures to abandon their house or their business. As indicated previously, lenders do not cite loan delinquency for business as a problem. Similarly, arrears in mortgage payments are low -- only ½ of 1 per cent of chartered banks' residential mortgage portfolios.

At the same time, all borrowers, including those who will be able to arrange financing, will have to make adjustments in budgeting or operations. Government needs also to examine if the nature of the adjustments or the extent of adjustments are such that borrowers should not be forced to make them, or should not have to bear the full adjustment themselves. In this regard, the rapidity of the increase in rates is an important consideration.

For large corporate borrowers and government, higher interest rates require adjustments in current operations and planning. Consumer purchasing will also be slowed. Adjustments can be made to weather higher rates over the short term. It will dampen the economy, but this is the result that must be expected from pursuing a high interest rate policy. Each type of borrower has differing amounts of flexibility and different considerations come into play for each.

In the Province of Ontario, it is estimated that there would be less than 20,000 households that might experience affordability problems at rates of 16 per cent. In each of these cases, the reasons for the affordability crisis should be

clear. Generally, it will reflect that income growth or the underlying value of the asset cannot sustain higher interest rates. Because of the social priority attached to home ownership, government may wish to take steps to prevent loss of the home. This would recognize that home ownership is, for most families, a purchase of shelter rather than an investment.

At the same time, the rapidity of the interest rate increase means that adjustments by homeowners will be more difficult than if more time had been available to adjust budgets. Homeowners who achieved below average increases in income will face greater difficulty in adjusting, as will families who have used their additional income to finance other debt purchases. Similarly, persons who negotiated short term mortgages will not have experienced an increase in income commensurate with payment growth. A more general temporary subsidy program could be contemplated to provide short term relief to allow time for adjusting to higher rates. It is to be noted that the recent downturn in rates has reduced the number of homeowners that have to face substantially higher rates of interest. In fact, given current trends and the expectation by some experts of lower rates by year-end, a strong case cannot be made for such a program. Financial institutions are assisting the majority of homeowners in the adjustment process.

With small business, different considerations come into play. In particular, operating a small business enterprise is subject to the vagaries of economic performance. Such risk is expected in return for the possibility of substantial gains.

Farming is effectively a business enterprise and the same considerations which were discussed for small business could be applied for farmers. What distinguishes farming from other business, however, is the particular importance that is attached to the product it produces.

As noted, lenders say that most viable farms will receive sufficient financing to continue operations. Given the high component of interest costs in many farming enterprises, the lag between expenditures and receipts and the direct impact of increased food costs in the Consumer Price Index, it can be argued that food related farming should receive interest rate support. There is obviously top priority in ensuring food supplies at stable prices. But at the same time, any relief should be temporary -- in respect of the 1980 crop cycle.

Financing considerations are important in determining the role of government. Any direct intervention by government will have some explicit costs. In examining possible alternatives, it is necessary to consider how each could be financed. Costs of programs within the Province of Ontario will vary widely according to the type of program contemplated.

These costs could be met by tax increases or borrowing. The former approach spreads the burden of government assistance over current taxpayers, while borrowing leaves the burden with future taxpayers. No matter which approach is taken, however, taxpayers will foot the bill. It cannot be taken for granted that interest subsidies will generate economic growth and pay for themselves.

Minor costs associated with temporary, specific programs do not raise major concerns of tax policy for government. But long term programs which involve large scale assistance or structural change to the tax system are a significant concern.

The following figures indicate the flexibility available to the Province: the personal income tax currently raises \$79 million per point; the retail sales tax yields \$328 million per point; and, the corporate income tax yields \$78 million per point. Consequently, the financing implications of even a relatively

modest assistance scheme can require a significant increase in tax rates. Major structural changes could not be financed by the Province on its own. The federal government has the potential resources to better finance such large expenditures. However, Ottawa is already facing severe pressures for tax increases to meet existing requirements.

It is possible that lower cost options could be financed by higher borrowing without seriously damaging the drive to free up financial resources for productive private uses necessary in the long run fight against inflation. But any large-scale borrowing will compound the problems of high deficit financing already facing the federal government and contribute to the inflationary pressures that the program is designed to offset.

VI MECHANISMS FOR AMELIORATING THE IMPACT OF HIGH INTEREST RATES IN THE SHORT TERM

The previous section has indicated that there may be a role for government in the short term to assist certain persons or businesses in accommodating higher interest rates. Analysis of information and discussions with lenders indicate that the role for government, if any role is appropriate at all, should be temporary and geared to hardship. However, the government should examine more general policies in the context of broader social needs and priorities.

Short term assistance, if deemed necessary, could be carried out by either federal or provincial levels of government or through cooperative effort. The major concern is that any policy must be carefully coordinated and designed so as not to undermine the achievement of greater stability for the economy in the future.

This section addresses the various types of approaches available to government to deal with the issue of interest rate assistance. These are:

1. Support private sector efforts to make interest rates affordable.
2. Limited subsidies for those most in need.
3. Direct subsidization of interest rates for borrowers.
4. Tax breaks to reduce the cost of borrowing and lending.
5. Direct credit market intervention.

Support Private Sector Initiatives

In most cases, borrowers, with the cooperation and support of the financial institutions, will be able to cope with the increases in interest costs. The financial institutions have long experience to draw upon in arranging to assist individuals and homeowners with unforeseen disruptions in financial circumstances. Indeed, it is in the interest of financial institutions to do so. They are only too willing to assist borrowers who approach them for assistance. The experience that institutions have in this regard will be invaluable. Indications are that interest rates have peaked and, although they remain relatively high in nominal terms, they

appear to be on the way down. This will further increase the affordability inherent in private sector initiatives.

Some entities for whom the maintenance of the home or business was a struggle to begin with will face added difficulties under high interest rates. However, as interest rates fall, even these should be able to cope better.

Limited Subsidies Based on Need

In addition to encouraging lenders to exercise their good offices in accommodating borrowers, government could consider a program of specific, short term relief structured on the basis of affordability. There is no general consensus as to the relevance of affordability and how it is measured. It depends on the nature of the borrowing. For example, affordability may take on a greater significance for the homeowner than for the businessman, since the owning of a home does not carry the same risk connotations that owning a business does.

There is a consensus that any proposed relief based on ability-to-pay should be temporary. By specifically focusing relief, not only would costs be kept down, but there would be minimal distortion of the capital markets.

Homeowners -- Gross Debt Service Ratios

Some homeowners may not be able to afford to carry their homes at high interest rates. There are different ways to measure affordability, but the generally accepted measure for households is the proportion of family income devoted to principal, interest and taxes -- or gross debt service ratios (GDS).

Generally, the market uses 30 per cent of family income in principal, interest and taxes as a ceiling on affordability. Persons whose carrying costs exceed 30 per cent would likely be unable to arrange mortgage financing. The government could design relief to integrate with this market determination and provide subsidy payments to individuals whose carrying costs exceed 30 per cent of income. It could be an option to set the ratio slightly higher to encourage borrowers to increase their participation somewhat and prevent government from absorbing the burden entirely.

It is recognized that this measure is not perfect. Affordability is basically a question of individual circumstances, reflecting other debt load, willingness to draw down assets, etc. The price of borrowed money is only one factor which determines the amount of a family's resources which must be devoted to homeownership. The price of the home, size of the down payment and the performance of income are also important factors. The 30 per cent test is not able to isolate the total impact of interest rates on affordability. But it is likely the most workable way to try to get at this concept.

In recognition of problems with the above criterion, relief could be made available only in those situations where the 30 per cent test would be met if interest rates were at a more acceptable level. Limits on mortgage principal eligible for assistance or income tests of some kind could be considered to focus relief more onto lower income classes.

A time limit on relief measures is necessary. As interest rates fall and as income grows, payments become more affordable. Furthermore, time gives the flexibility to reassess priorities and readjust family budgets.

The time period for eligibility could be adjusted depending on the amount of resources available for the program and the judgment as to the severity

of current high interest rates. Interest rates began their acceleration late in 1979. Mortage rates peaked at 17 per cent in April, but have declined rapidly and mortgages are now available at 12.5 per cent. The number of mortgage renewals will be greatest during the summer months.

Lenders have experienced few affordability problems with home-owners thus far. In cases where there appears to be hardship, the financial institutions work closely with the borrower to make workable arrangements and hence, they are familiar with the financial details of cases where there is financial difficulty.

In view of this, it would be useful to obtain assistance of lenders identifying clientele for a program if government assistance were contemplated. Lenders would employ all possible market means to make monthly payments fall within the 30 per cent GDS criterion. Where this is not possible, the borrower would be referred to the government. The assisting government would assess the extent of relief necessary and make payments.

In terms of impact, the amount of relief would depend upon income, the size of the loan and interest rate. Table 27 indicates the sensitivity to these factors of the amount of relief required to bring GDS down to 30 per cent of income.

Monthly Assistance Required to Meet 30 Per Cent
GDS Criterion
(dollars)

Table 27

1. On a Mortgage at 16 Per Interest	Outstanding Principal in 1980			
	<u>20,000</u>	<u>30,000</u>	<u>40,000</u>	<u>50,000</u>
<u>Gross Income</u>				
10,000	53	n.a.	n . a.	n . a.
15,000	0	81	233	n . a.
20,000	0	0	108	260
25,000	0	0	17	135
2. On a \$30,000 Outstanding Principal at Various Mortgage Rates	Mortgage Rates			
	<u>14%</u>	<u>15%</u>	<u>16%</u>	<u>17%</u>
<u>Gross Income</u>				
10,000	n.a.	n.a.	n . a.	n . a.
15,000	40	60	81	102
20,000	0	0	0	0
25,000	0	0	0	0

Source: Ontario Treasury calculations.

- Notes:
1. Assumes property taxes of \$400, \$600, \$800 and \$1,000 for a \$20,000 mortgage, \$30,000 mortgage, \$40,000 mortgage and \$50,000 mortgage, respectively.
 2. Assumes 20-year amortization period remaining in 1980.
 3. n.a. means not applicable, as would be unlikely to be considered for a mortgage because of insufficient income.

As many as 20,000 rollovers in Ontario in 1980 could experience difficulty meeting a 30 per cent GDS criterion at a 16 per cent rate. The cost of assisting these persons for one year is estimated in the \$15 to \$20 million range. At current rates, the numbers requiring assistance and the costs would be much lower.

Because of the lack of a clear cut definition of affordability, and the difficulty with designing a measure sensitive to individual efforts, relief could take the form of a loan as opposed to a grant. By making relief an interest-free loan, government would not be subject to the criticism that it was penalizing the prudent or more careful planner who makes adjustments to changing circumstances and lives more within his means.

The federal government has indicated it intends to protect those persons who participated in the AHOP program from the full shock of higher interest rates. Further, it has said that other homeowners who face affordability problems will be given assistance. Details of this assistance are yet to be announced. In this regard, the Province has forwarded to the federal government a proposal by which non-AHOP homeowners would be assisted.

The basic features of this program are:

- . triggered by a GDS in excess of 30 per cent;
- . loan from CMHC of up to \$500 per year to reduce GDS;
- . if loan interest does not reduce GDS to 30 per cent, Province will provide additional grant assistance of up to \$500 per year;
- . first and second mortgages totalling up to \$45,000, where the first mortgage becomes due between June 1, 1980 and May 31, 1981 would be eligible; and,
- . relief will be provided for one year.

It is anticipated that this mechanism would cost in the range of \$15 to \$20 million in Ontario.

Farmers: Easing the Income Squeeze

The lending institutions have indicated that where a farm is well-managed and is a viable entity in the absence of high interest rates, they are willing to carry the farmer through this period of difficult circumstances.

Nonetheless, some farmers will feel an unacceptable squeeze on incomes. Some sort of needs-based relief would indicate that the government feels farming is an important activity.

However, there is no convenient, widely accepted measure of need for farmers as exists for homeowners. Need varies according to type of farming activity, other debts, etc. One approach would be to relate interest costs to farm income. Farms with higher interest burdens would be more vulnerable, but there is no established ratio that is felt to pinpoint where difficulties begin. Other possible measures of difficulty for farmers are operations where liabilities are in excess of equity. Or relief could be focused on types of farming where problems are known to exist. For example, cash cropping and hog/sow finishing operations seem particularly vulnerable to high interest rates due to the importance of interest costs in operating costs, and the reduced income prospects at this time. Similarly, focusing relief on young farmers would recognize that they are likely to have higher debt because of their recent entry into the field.

Small Business

Lending institutions have also indicated that they are willing lenders to small businesses that are well managed and potentially successful entities in the absence of high interest rates. The fact that business is by nature a risky venture and bankruptcy is always possible, and the difficulty in identifying need due to high interest rates, raises doubts as to the appropriateness of a needs-based policy for small business. At the same time, it should be remembered that the recent Budget proposed \$50 million in tax savings for small business and ODC is providing significant assistance.

Direct Rate Subsidization

Government could enter into a program of broadly based interest subsidization for small business, homeowners and/or farmers. A universal program would have the advantage of providing equal relief to all members of this vital segment of our economy from these temporary difficult circumstances. This approach recognizes that the rapidity of the increase in interest rates causes problems of adjustment for each of these groups. There would be no question of bonusing the imprudent or poor managers while leaving those who make concerted efforts to live "within their means" to fend for themselves. No value judgments concerning need would be necessary.

Relief would be based on the value of a defined number of interest points in excess of some floor which is deemed to be the appropriate level. The number of points subsidy itself could be subject to a maximum in order to contain costs.

The subsidy would operate on the basis of the interest rate contracted. Limits could be established on the amount of loan eligible for subsidy or the amount to be paid. It would be possible to vary these limits by type of borrower to recognize differing amounts of capital required by various borrowers.

This approach has major cost and administrative implications. The broad based nature of relief and the lack of data make it difficult to pinpoint costs, but they would be sizeable. In Ontario, costs of \$50 million per point appear reasonable for homeowner subsidization. There are over 40,000 commercial farmers, most of whom make use of borrowing. Requirements for operating capital vary widely, but costs in Ontario would likely be in the range of \$10 million per point. It is impossible to estimate the take up by small business, but suffice it to say that with a potential clientele of well over 200,000, costs would be substantial as well.

The bureaucracy to deal with hundreds of thousands of clients would have to be established. In this regard, homeowners and small businessmen create the bulk of the administrative workload due to the sheer size of clientele involved. Lenders could serve as sources of information on eligibility. Lenders would have to police the system to ensure continued payment by the borrower.

Other concerns include the fact that more widespread subsidization of rates would constitute wide scale interference in capital markets and there may be distortions in use of capital. Small business people or farmers may extend themselves further than they would otherwise.

In addition, there are the issues of recapture by lenders, who are currently operating with tight margins, and the burden on private lenders who do not have the resources to provide a major role in administering the system.

A variation on the theme of interest subsidies is the concept of low interest loans by government. The concept is not viable for homeowners because of the prohibitive amounts of capital required to provide the upfront loan. The concept is used to some extent now for farmers -- i.e. capital assistance to young farmers and tile drainage. For small business, an expansion of the terms of the Federal Small Business Development Loan Act to include inventory could be considered. The program currently guarantees loans for fixed assets to 90 per cent, with a maximum guarantee of \$100,000. Including inventory would provide a source of somewhat cheaper operating capital, although the fact that it is tied to prime would still leave small business subject to sudden swings in the cost of capital such as that experienced currently.

The Farm Interest Assistance Program

The Government of Ontario introduced the Farm Interest Assistance Program to offset the impact of interest rates on farmers. Although interest rates are currently declining and the prospect is for lower rates, farmers did have to borrow in the early Spring when rates were at their peak. Coupled with rising costs for many inputs to production, farmers are facing a significant income squeeze. The new program is a measure designed to enhance the long term viability of food farming in the face of short term pressures.

The program is designed to provide food farmers with a subsidy of up to three points for a period of up to nine months. The program is expected to cost \$25 million. Appendix A provides details of this program.

Tax Relief

Relief from high interest costs could be achieved through tax breaks for homeowners, business and farmers in respect of interest paid.

The issue of tax relief is fundamentally different for business and homeowners. Farmers and small business are already implicitly protected from the bite of high interest cost as interest expense is a deduction from taxable income. Interest costs are an expense of earning that income. Thus, from the point of view of fair taxation it is appropriate that interest is deductible from business and farm income.

Greater relief for business from high interest rates could be delivered via an increase in the interest deduction. Relief would be focused on profitable companies, and could result immediately through reduced tax installment payments. Business organizations have indicated that the delivery of relief through

the income tax system would be preferable in order to focus relief on profitable companies and minimize government involvement.

For homeowners, tax assistance raises some very basic questions of personal income tax policy. Mortgage interest costs are not a cost of earning income, so there is no legitimate reason to allow interest costs to determine income which should be subject to tax. Rather, it is a question of tax preference. Tax relief for homeowners would have to be justified on the basis that the government wished to support homeownership via the tax system. This is a question which has been debated considerably recently with the former federal government's attempt to introduce mortgage interest credits.

The arguments centre around the long term viability of homeownership and whether further resources need to be directed to this sector. The impact of the current fluctuations in interest rates is a short term problem. Structural changes in the personal income tax do not appear to be an appropriate means of addressing the temporary problem of high interest rates. As well, it would be extremely costly.

On the supply side, tax relief for lenders would operate to provide cheaper capital for selected borrowers. Instruments similar to tax-free municipal bonds in the U.S. could be introduced for specific types of borrowing. The federal government, in fact, has proposed a Small Business Development Bond. The above mechanisms are vehicles for reducing the cost of capital for borrowers by reducing the after tax cost of money to lenders. Other special tax exemptions could achieve the same goal.

To be effective, however, such mechanisms would have to have some degree of permanence to encourage the financial community to adjust their investment policies. It is not feasible to set up an instrument such as a tax exempt

bond for a single period. Even if it were feasible, changes made to the tax system, where money is being given out, are difficult to reverse. These tax related measures are tantamount to dealing with temporary, short term problems via long term structural change.

As well, measures to assist specific sectors are more likely to divert the flow of capital from one area of the economy to another and not result in a net increase in supply. The delivery lag that is implicit in using the tax system would also make relief less effective. In fact, for those who find themselves in desperate circumstances, it would be useless. In view of the nature of the current interest rate problem, this option is not reviewed in detail.

Regulation of Capital Markets

Intervention in the capital market is a mechanism by which the government could lower interest rates for certain segments with no direct costs.

Controls could take a number of forms. Some examples are an extension of existing mortgages for one year, surcharges on low priority types of borrowing hence allowing more and cheaper funds to be available for mortgages, small business and farmers; and, in the most extreme application, actually fixing rates at what is deemed to be an appropriate affordable level.

This approach could be implemented only by the national government, both because of its constitutional jurisdiction in the area of money and credit and from a practical viewpoint because of the free flow of borrowing and lending among provinces.

This approach has severe and dangerous untoward side effects. Ceilings on rates would mean that the supply of funds for these particular

regulated uses would dry up as market rates exceeded the ceiling. But demand for this type of funds would exceed normal market requirements as its price would be artificially low relative to other uses of funds. Thus, legislation on the supply of credit would have to be considered as well.

Legislation of all rates of return is a complete change in the direction of Canadian monetary policy. The implications of such a course of action have been discussed in the first section of this paper. It can only be pursued in the belief that the credit market is not functioning properly and nothing short of direct government involvement can rectify the situation.

CONCLUSION

This paper does not offer a blueprint of solutions to all of Canada's economic problems. It has a more modest, but not less valuable objective. It argues that when Canadians look to solutions to the high interest rate problem, they should look past the high rates themselves to ultimate causes. In many ways, as this paper suggests, high interest rates are a symptom of much more fundamental problems in the Canadian economy. In the long run, it is the underlying problems that must be addressed. Many, if not most, encompass national economic policy issues. At the heart are the central objectives of greater and more balanced economic growth, both regionally and industrially, and a much lower rate of domestic inflation.

To some degree, these goals may require a new set of policy instruments and new levels of intergovernmental cooperation. Ontario has contributed a number of suggestions in this regard.¹² There are many others that could be reviewed to determine their effectiveness in the current situation. What is required is a detailed examination in many different forums of all the economic policy options. The nation's major economic research institutes in both the private and public sectors could be invited to direct their considerable resources to evaluating feasible alternatives open to governments. Such initiatives might then be subject of review by a forum of First Ministers and Ministers of Finance.

¹² The Honourable William G. Davis, Premier of Ontario, Economic Priorities for Canada, Conference of First Ministers on the Economy, November 27-29, 1978, Ottawa, Ontario; and, the Honourable William G. Davis, Premier of Ontario, An Economic Development Policy for Canada, Federal-Provincial Conference of First Ministers, Ottawa, February 13-15, 1978.

APPENDIX A

Farm Interest Assistance Program

Objective

This program is aimed to provide financial assistance to farmers who are experiencing high interest costs on short term money that is borrowed for the planting, growing, harvesting, and production of 1980 food crops and livestock. The program is effective from April 1 to December 31, 1980.

Amount of Assistance

The Government of Ontario will provide a subsidy on short term operating loans for interest paid above 12 per cent to a maximum of 3 per cent. The maximum amount of loan to which the subsidy will apply is \$75,000. And the maximum time period for the interest subsidy is 9 months. Hence, the maximum subsidy is \$1,687.50 ($\$75,000 \times .03 \times 3/4$ year).

Eligibility

The subsidy is available to farm owners or operators who produce food crops or livestock. It is limited to commercial farmers whose gross income from farming was \$8,000 in the twelve months immediately preceding application. Farm debt must be 25 per cent or more of farm assets at some point during the year. Funds may be borrowed for the purchase of productive items such as seed, fertilizer, fuel, sprays, twine, feeder cattle, feeder pigs, machinery repairs, purchased feed, hired labour, etc. Monies used for the purchase of capital items such as farm machinery and quotas and for personal use items are not eligible under this program.

Only loans from financial institutions including banks, trust companies and credit unions are eligible.

Program Cost

This program is expected to deliver \$25 million in interest relief to Ontario's food producers. If the interest rates paid by farmers fall below 15 per cent, the need for subsidy will be reduced and accordingly costs will be lower.

Application

Farmers may obtain application forms shown here from their local Ministry of Agriculture and Food Office or from financial institutions.

When short term credit needs are complete or on December 31, 1980 the farmer fills out the application form. The amount of loan and the rate of interest paid are to be certified by an authorized lending official. The farmer himself signs an affidavit stating that all information on the form is correct and has the form witnessed. The application is made to the Ministry of Agriculture and Food and the subsidy cheque is mailed to the farmer.

HG Discussion paper on
1623 interest rate policy.
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